

For discussion  
on 2 April 2004

**Legislative Council  
Panel on Financial Affairs**

**Consultation Conclusions  
on Proposals to Enhance the Regulation of Listing**

**INTRODUCTION**

This paper is to inform Members of the publication of the Consultation Conclusions on Proposals to Enhance the Regulation of Listing (the “Consultation Conclusions”) on 26 March 2004, which sets out measures to improve the regulation of listing to enhance market quality.

**BACKGROUND**

2. At the meeting of the LegCo Panel on Financial Affairs on 13 June 2003, we briefed Members on the Administration’s plan on how to take forward the recommendations of the Expert Group to Review the Operation of the Securities and Futures Market Regulatory Structure. After the meeting, the Administration, in its letter to the Panel dated 30 June 2003, undertook to commence the consultation process in the third quarter of 2003, and update the Panel of the consultation exercise.

3. The Administration published a Consultation Paper on Proposals to Enhance the Regulation of Listing on 3 October 2003 to invite public views on, inter alia, the proposal for giving statutory backing to certain fundamental listing requirements, and on ways to improve the regulatory structure governing the performance of listing functions. Following the public consultation, the Administration released the Consultation Conclusions on 26 March 2004. The press release and the Consultation Conclusions issued on 26 March 2004 are at **Annex A** and **Annex B** respectively.

4. Members are invited to note the recommendations in the Consultation Conclusions.

Financial Services Branch  
Financial Services and the Treasury Bureau  
26 March 2004

**Press Release**

**Government Announces Measures to Enhance the Regulation of Listing**

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The Government has taken the lead in drawing up measures to improve the regulation of listing to enhance market quality, following public consultation on Proposals to Enhance the Regulation of Listing, according to the Consultation Conclusions released today (March 26).

“We are pleased to note that there is overwhelming support for giving statutory backing to certain fundamental listing requirements and expanding the dual filing system,” the Secretary for Financial Services and the Treasury, Mr Frederick Ma, said.

“The proposed improvement measures set out in the Consultation Conclusions will contribute towards a quality market. They will further strengthen our position as the premier capital formation centre for the Mainland and a major international financial centre in the region.”

“We will work closely with the Securities and Futures Commission (SFC), the Hong Kong Exchanges and Clearing Limited (HKEx) and all market users towards this common goal,” Mr Ma said.

The Consultation Conclusions recommend codifying in the statute the more important listing requirements, i.e. financial reporting and other periodic disclosure, disclosure of price-sensitive information and shareholders’ approval for notifiable transactions. This will be achieved by subsidiary legislation to be made by the SFC under s.36 of the Securities and Futures Ordinance (SFO).

In parallel, the Government will introduce a Securities and Futures (Amendment) Bill into the Legislative Council to the effect that breaches of statutory listing requirements will become a new type of market misconduct. Any persons who breach the statutory listing requirements can either be subject to civil sanctions imposed by the Market Misconduct Tribunal under Part XIII of SFO, or criminal sanctions under Part XIV of SFO following prosecution.

Mr Ma said, “Any breach of statutory listing requirements would not only hurt our investors, but also tarnish the reputation of our equity market. By bringing the regulatory regime for listing in line with that for other types of market misconduct, such as insider dealing and stock market manipulation, we hope to demonstrate to the local and international investors our commitment to enhancing market quality.”

To address market calls for swift actions to be taken by SFC, the Government will also amend SFO to allow SFC to impose direct civil sanctions, namely reprimands and disqualification orders, on specific, well-defined “primary targets” for breaches of the statutory listing requirements. It is the consensual view among the regulators that these “primary targets” should be the issuers, directors and corporate officers, who are primarily accountable for corporate disclosure and other corporate activities under the listing regime.

“We shall continue to rely on the regulatory framework under SFO, in particular the licensing regime, for SFC to regulate IPO sponsors. We note the efforts being made by SFC and HKEx to upgrade the regulation of sponsors,” Mr Ma said. “We recommend that they should expedite action on this front.”

Mr Ma noted that the Government aimed at introducing the Securities and Futures (Amendment) Bill into the Legislative Council in early 2005, as pledged by the Financial Secretary in his Budget Speech for 2004-05.

“To facilitate consideration of the Amendment Bill by the legislature and the public, we have invited SFC to endeavour to expose the draft rules on the more important listing requirements for public consultation before the Amendment Bill is introduced into the Legislative Council.”

“The Government, SFC and HKEx will together review the need to extend the scope of these statutory rules to cover other listing requirements, in light of the regulatory experience, public reaction and market development needs,” he added.

With these legislative changes, the existing dual filing system will be expanded accordingly. SFC will be responsible for enforcing the existing as well as the new statutory listing requirements.

“The Stock Exchange of Hong Kong Limited (SEHK) will continue to receive listing applications at the frontline, and no securities will be listed on SEHK unless they are approved by the SEHK Listing Committee,” Mr Ma said.

The Consultation Conclusions also recommend a number of improvement measures to enhance the transparency and accountability of the performance of listing functions by both SFC and HKEx as follows –

- (a) SFC and HKEx to enhance the transparency of their decisions relating to listing;
- (b) SFC and HKEx to articulate in a public statement their division of responsibilities relating to listing;
- (c) SFC to submit its reports on annual audit of HKEx’s performance of listing functions to the Financial Secretary, who shall cause the reports to be published;
- (d) SFC’s regulatory oversight of HKEx’s performance of listing functions to be a subject of regular review by the Process Review Panel (PRP);
- (e) SFC and HKEx to invite the Independent Commission Against Corruption (ICAC) to study their respective procedures and practices for the performance of listing functions under the dual filing system; and
- (f) monitoring of the implementation of improvement measures identified by ICAC’s study through SFC’s annual audits of HKEx Listing Unit, and PRP’s annual reports on SFC’s due process.

“We look forward to the continuing support by both SFC and HKEx for the early implementation of the legislative and administrative measures to enhance the effectiveness, transparency and accountability of the listing regime,” Mr Ma said.

The Financial Services and the Treasury Bureau published on 3 October 2003 the Consultation Paper on Proposals to Enhance the Regulation of Listing. The Consultation Conclusions are available on the website of FSTB at [www.info.gov.hk/fstb/fsb](http://www.info.gov.hk/fstb/fsb).

End/Friday, March 26, 2004

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## **GLOSSARY**

<b>“Carve-out”</b>	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 the statutory provisions.
<b>Disqualification order</b>	In s.257 of the Securities and Futures Ordinance, a disqualification order refers to an order that the person shall not, without the leave of the Court of First Instance, be or continue to be a director, liquidator, or receiver or manager of the property or business, of a listed corporation or any other specified corporation or in any way, whether directly or indirectly, be concerned or take part in the management of a listed corporation or any other specified corporation for the period (not exceeding five years) specified in the order.
<b>Dual filing</b>	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 under s.384 of the Securities and Futures Ordinance to take action against knowingly or recklessly false or misleading disclosure.
<b>HKEx</b>	The Hong Kong Exchanges and Clearing Limited. It is the holding company of the Stock Exchange of Hong Kong Limited.
<b>IPO</b>	Initial public offering.

**Listing requirements**

We have used this term in the Consultation Conclusions in general to refer to all requirements concerning admission to listing and ongoing obligations of listed companies. They are now contained in –

- (a) the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited;
- (b) the Rules Governing the Listing of Securities on the Growth Enterprise Market of the Stock Exchange of Hong Kong Limited;
- (c) the Securities and Futures (Stock Market Listing) Rules made by the Securities and Futures Commission under the Securities and Futures Ordinance; and
- (d) Parts II and XII of the Companies Ordinance.

Those requirements in (a) and (b) are non-statutory, whereas those in (c) and (d) are statutory.

***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**

The Market Misconduct Tribunal established under s.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”**

The non-statutory 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.

<b>SEHK</b>	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.
<b>SEHK Listing Committees</b>	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.
<b>SEHK's Listing Rules</b>	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.
<b>SFC</b>	The Securities and Futures Commission. It is the statutory regulator of the securities and futures market.
<b>SFO</b>	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.
<b>SFSMLR</b>	Securities and Futures (Stock Market Listing) Rules made by the Securities and Futures Commission under s.36 of the Securities and Futures Ordinance. They provide for the “dual filing” system.

## EXECUTIVE SUMMARY

1. Hong Kong has over the last two decades developed itself into a major international financial centre and premier capital formation centre for the Mainland. Our market has proved to be attractive to issuers and investors around the globe and has become a focal point for world class intermediaries. Amidst the recent upswing in our economy, the equity market has witnessed encouraging developments, with a number of major initial public offerings (IPOs) that have drawn the interest of local as well as international investors. The secondary market is no less vibrant – in the past five months, the average daily turnover exceeded \$17 billion. With a total market capitalisation of over \$6,170 billion as at end February 2004, the Hong Kong stock market ranked 8<sup>th</sup> in the world and second in Asia.<sup>1</sup>
2. There is no room for complacency. We must ensure that the business environment and regulatory system are conducive to building a quality market which is fair, open and transparent for all users to operate. We cannot lose sight of the need to protect our market from being tainted by companies with poor governance. Episodes of corporate misconduct in recent years call for action to improve the regulatory system.
3. The Government attaches great importance to the listing functions which are shared by the Securities and Futures Commission (SFC) and Hong Kong Exchanges and Clearing Limited (HKEx) to provide the important gatekeeping and ongoing supervisory services for the equity market. We have therefore taken the lead in drawing up improvement measures in light of public comments on the Consultation Paper on Proposals to Enhance the Regulation of Listing issued on 3 October 2003. We are thankful to SFC and HKEx for their input to the development of improvement measures, and will continue to enlist their support in bringing these measures to early fruition.
4. We are pleased to note from the public comments received that the dual filing system has been operating smoothly since its implementation in April 2003, and has been generally well received by market users. The market recognises that the system has

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<sup>1</sup> Source of data on market capitalization: the World Federation of Exchanges.

contributed to the strengthening of the gatekeeping mechanism of the listing regime.

5. However, the lack of regulatory teeth in the Listing Rules administered by the Stock Exchange of Hong Kong Limited (SEHK)<sup>2</sup> (“the Red Book”)<sup>3</sup> has remained an issue of concern to the market as well as the general public. Though the dual filing system has rendered knowingly or recklessly false and misleading disclosure in listing documents and ongoing disclosure materials an offence under the Securities and Futures Ordinance (SFO), it does not create any statutory liabilities for listing applicants or listed companies which breach other important listing requirements. In view of strong public support, we recommend giving the more important listing requirements statutory backing, to create a statutory obligation for compliance with these requirements, including the need to ensure accurate, timely and full disclosure.
6. To achieve this, we recommend codifying the more important listing requirements in statutory rules to be made by SFC under s.36 of SFO. The Government, with the support of SFC and HKEx, will take the lead in improving the regulatory framework by amending the primary legislation. We also recommend extending the market misconduct regime under Parts XIII and XIV of SFO to cover breaches of these SFC rules. Breaching statutory listing requirements would become a new type of market misconduct, subject to the same dual civil and criminal treatment as the other six types of market misconduct<sup>4</sup> stipulated in SFO.

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<sup>2</sup> SEHK is the operator of the Main Board and the Growth Enterprise Market and is a subsidiary of HKEx.

<sup>3</sup> The SEHK’s Listing Rules refer to rules governing the listing of securities on SEHK and are commonly referred to by market practitioners as the “Red Book”.

<sup>4</sup> These are insider dealing, stock market manipulation, false trading in securities or futures contracts, price rigging in securities or futures markets, disclosure of information about prohibited transactions in securities or futures contracts, disclosure of false or misleading information inducing transactions in securities or futures contracts.

7. To encourage compliance and deter breaches, we recommend a three-pronged approach to deal with non-compliance with the statutory listing requirements. Consequences for breaching the statutory listing requirements would include -
- (a) direct civil sanctions, namely reprimands and disqualification orders to be imposed by SFC on the “primary targets”, namely the issuers, directors and corporate officers<sup>5</sup>, as appropriate; and/or
  - (b) referral by SFC of such breaches by any persons, to the Secretary for Justice (SJ) who will decide whether to bring criminal prosecution under Part XIV of SFO, **or** advise the Financial Secretary (FS) to consider instituting civil proceedings before the Market Misconduct Tribunal (MMT) to enquire into the misconduct under Part XIII of SFO.
8. We recommend adopting a phased and focused approach to giving statutory backing to the more important listing requirements. Based on public comments, in Phase I, priority should be given to preparing statutory rules on the more important listing requirements, i.e.-
- (a) financial reporting and other periodic disclosure (e.g. annual and interim reports) by listed companies;
  - (b) disclosure of price-sensitive information by listed companies; and
  - (c) shareholders’ approval for certain notifiable transactions.

We recognise that the making of these statutory rules, like other statutory rules made by SFC, will be subject to the usual checks and balances laid down in SFO.

9. There is also an overwhelming support for SFC as the statutory regulator to enforce the new statutory listing requirements. We see merit in entrusting this responsibility with SFC as it has the investigative power that is necessary for the effective enforcement of statutory listing requirements laid down in rules made under s.36 of

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<sup>5</sup> According to Schedule 1 to SFO, “officer” (高級人員), in relation to a corporation, means a director, manager or secretary of, or any other person involved in the management of, the corporation.



SFO. The division of responsibilities would thus be clear – SFC would be responsible for enforcing statutory listing requirements, while HKEx would continue to enforce the non-statutory listing requirements as provided for in its Red Book.

10. As for the regulatory structure governing the performance of listing functions, we recommend expanding the existing dual filing system in light of general public support. SEHK will continue to receive IPO applications at the frontline and no securities will be listed on SEHK unless they are approved by the SEHK Listing Committee. SEHK will remain responsible for administering the listing process. It will remain the primary point of contact for listing applicants and their advisers. This should avoid creating additional administrative burden on the part of listing applicants and their advisers. During the processing of a listing application, SFC would detect any non-compliance with the statutory listing requirements, and assess whether it should exercise its statutory power to object to the listing application. HKEx would vet the documents to assess the applicant's eligibility for listing. As for ongoing compliance of listed companies, the same division of labour between SFC and HKEx would apply, i.e. SFC would be responsible for enforcing the statutory listing requirements, while HKEx would continue to enforce the non-statutory requirements in the Red Book. SFC will be able to exercise statutory enforcement powers where it has reasons to believe that there are breaches of statutory listing requirements.
11. Similar to existing arrangements, all documents filed with SEHK are also to be filed with SFC. In this way, SFC would be in a position to detect any suspected breaches of the statutory listing requirements. SFC will continue to have the statutory powers to deal with breaches as set out in the current Securities and Futures (Stock Market Listing) Rules, including its existing power to object to listing. In addition, SFC will be vested with new powers to impose civil sanctions on certain specific, well-defined "primary targets", viz. issuers, directors as well as corporate officers. SFC will also be responsible for referring breaches to SJ who will decide whether to bring criminal prosecution under Part XIV of SFO, or advise FS to consider civil proceedings before MMT under Part XIII of SFO as discussed in paragraph 7(b) above. Either MMT or the court may impose sanctions on any persons who are found to have breached the statutory listing requirements.

12. In view of public concerns about the transparency and accountability of the performance of listing functions, we recommend the publication of reports on SFC's annual audits of HKEx's performance of listing functions, and the implementation of measures to enhance the transparency of decisions made by SFC and HKEx relating to listing. We also recommend SFC and HKEx to invite the Independent Commission Against Corruption to study the procedures and practices of both SFC's Dual Filing Team and HKEx's Listing Unit (including the operation of the SEHK Listing Committee), with a view to removing any lingering doubts about the impartiality of the listing regime. We are pleased to note the positive response of SFC and HKEx Executives to these recommendations, and look forward to the early implementation of these improvement measures.
13. We believe that the proposed improvement measures set out in the Consultation Conclusions will be effective in improving the quality of our market. But we will not stop here. Improvement is a continuous process. We will continue our efforts on other fronts including the implementation of the Corporate Governance Action Plan introduced by the Government in 2003. We will also keep the listing regime under review to ensure that the regulation of listing will evolve in tandem with market needs and international trends.
14. As a major step in the implementation roadmap for these measures, the Government will aim at introducing a Securities and Futures (Amendment) Bill to the Legislative Council in early 2005 to extend the market misconduct regime to cover breaches of statutory listing requirements, and to provide for proportionate sanctions for such breaches. To facilitate consideration of the Amendment Bill by the public and the legislature, we have invited SFC to endeavour to expose the draft s.36 rules for Phase I (*c.f.* paragraph 8 above) prescribing statutory listing requirements before the Amendment Bill is introduced to the Legislative Council. We have also invited SFC and HKEx to consider early implementation of the administrative measures to enhance transparency and accountability of the listing regime set out in paragraph 12 above by phases starting in Q2 2004.

## CHAPTER 1 – INTRODUCTION

- 1.1 The Financial Services and the Treasury Bureau commenced the Consultation on Proposals to Enhance the Regulation of Listing (the Consultation) on 3 October 2003<sup>6</sup>. The Consultation formally closed on 31 December 2003, but we received a number of submissions after the deadline. In preparing the Consultation Conclusions, we have endeavoured to take into account these late submissions.
- 1.2 We have received 48 submissions from individuals, corporations, professional associations, trade bodies and regulators. Their submissions provide useful analysis of the issues involved and their first-hand practical experience in the listed sector. They have all made positive and constructive contributions to this consultation exercise, and we are thankful for their support. A summary of submissions received is at **Annex A**.

### POLICY OBJECTIVE – IMPROVING MARKET QUALITY

- 1.3 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. The Government's policy objective is clear - continuous improvement of the regulatory regime in respect of listing, with a view to enhancing market quality.
- 1.4 In arriving at specific proposals for enhancing market quality, the Government is guided by general market wisdom as to what a "quality market" entails. All submissions which have touched on this subject agree that in improving market quality with a view to attracting issuers, intermediaries and investors, reputation is the key. They also agree that this will invariably require improvements to the regulatory regime to create an effective deterrent against corporate misconduct that would damage the reputation of our equity market.

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<sup>6</sup> The full text of the Consultation Paper on Proposals to Enhance the Regulation of Listing is available at the website of the Financial Services and the Treasury Bureau: <http://www.info.gov.hk/fstb>.

## OVERVIEW OF COMMENTS RECEIVED

- 1.5 Against this background, there is an overwhelming support for introducing improvements, and a majority of the submissions agree to promote compliance/enhance market quality by including the more important listing requirements in the statute, i.e. introducing statutory listing requirements. As many submissions have pointed out, the current Listing Rules of the Stock Exchange of Hong Kong Limited (SEHK)<sup>7</sup> (the “Red Book”)<sup>8</sup> have already laid down comprehensive regulatory requirements, and these have been kept under regular review by the relevant parties in light of changing market needs and international trends. These parties include SEHK and its Listing Committees<sup>9</sup>, which initiate amendments to the Red Book, and SFC, which has the statutory power to approve such amendments. Based on the submissions received, the scope and content of the Red Book appear to have struck a balance for both the “sell side”, such as issuers, and the “buy side”, i.e. investors. But many submissions have pointed out the problem that the Red Book lacks the regulatory teeth to encourage compliance and deter breaches. It is the absence of proportionate and calibrated consequences for breaching the more important listing requirements in the Red Book that has drawn the concern of market users.
- 1.6 In fact, the lack of effective sanctions for non-compliance with the Red Book is the natural consequence of its non-statutory status. Whether the Red Book is administered by a commercial entity or a statutory regulator would not alter the present situation. Our assessment based on public comments is that, unless the more important listing requirements are included in the statute, the present unsatisfactory arrangement will perpetuate.

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<sup>7</sup> SEHK is the operator of the Main Board and the Growth Enterprise Market and is a subsidiary of HKEx.

<sup>8</sup> SEHK’s Listing Rules are non-statutory rules governing the listing of securities on SEHK and are commonly referred to by market practitioners as the “Red Book”.

<sup>9</sup> SEHK Listing Committees are set up by SEHK to perform functions and exercise powers in relation to listing matters delegated by the Board of HKEx. There are currently two SEHK Listing Committees, one for the Main Board and the other for the Growth Enterprise Market (GEM). For the purpose of the Consultation Conclusions, the term “Listing Committee” covers the SEHK Listing Committees for both the Main Board and GEM.

- 1.7 The submissions have also provided a lot of useful comments on the regulatory structure governing the performance of listing functions. Many of these comments have been substantiated by the market users' practical experience under the new dual filing system, which came into effect with the commencement of the Securities and Futures Ordinance (SFO) on 1 April 2003. We are pleased to note from the submissions received that the dual filing system has been operating smoothly since its inception, and has been well received by market users. It enables SFC to make use of the regulatory tools provided by SFO, including investigative powers and objection to listing, without adding an undue compliance burden on the part of issuers, or creating uncertainty in the market. There is a general consensus that we should build on the basis of the dual filing system to further strengthen our regulatory regime.

## **IMPROVEMENT AS AN EVOLUTIONARY PROCESS**

### **Status quo not an option**

- 1.8 The securities and futures industry is one of the four major pillars of our economy, and Hong Kong has established its position as a major international financial centre over the past two decades. Recent years have witnessed the rapid expansion and opening up of the Mainland market, and Hong Kong has successfully established itself as the premier capital formation centre for Mainland issuers. However, competition is keen. Other leading international markets are introducing various reforms to improve their listing functions. Many of these markets also have their eyes on the rapidly developing and expanding Mainland market. Maintaining the status quo is not an option. Inaction will only erode our competitiveness, and cost us lost opportunities in the longer run.
- 1.9 Although the three-tiered regulatory structure for the securities and futures industry has served us well for the past decade, we recognise that there is always room for improvement to meet market needs and global challenges. The need for timely improvements to the regulation of listing is echoed and shared by the market as well as the general public. It is necessary for us to take effective and prompt measures to improve our regulatory regime in light of market needs and international development. Indeed this is critical to the continued success of our market.

## **Need for continuous improvement**

- 1.10 We wish to emphasise that the regulatory regime governing listing has to be kept under regular review in tandem with changing market needs, having regard to Hong Kong's unique situation and international trends. Giving statutory backing to the more important listing requirements is undoubtedly a major step forward, but this alone would not guarantee our success. Upgrading market quality is a continuous process. It requires the concerted efforts of the Government, regulators and professional advisers, as well as support from all market users. The improvement measures discussed in the Consultation Conclusions would not and should not pre-empt further improvements in response to public demands and market needs.

## **Government's ongoing efforts to improve market quality**

- 1.11 Market quality is a multi-faceted subject. Improving the regulatory regime governing listing is necessary but not sufficient for strengthening our competitiveness as an international financial centre and the premier capital formation centre for our country. Market users, including the issuers, investors, professional advisers and intermediaries, must join efforts with the Government and the regulators in the drive to upgrade the quality of our equity market.
- 1.12 Alongside the enhancement of the regulation of listing, the Government, together with SFC and HKEx, have devoted considerable efforts to promoting good corporate governance, which is the pre-requisite for a quality market. We are pleased to see substantial progress made in implementing the Corporate Governance Action Plan introduced by the Government, in collaboration with SFC and HKEx, in early 2003. The more recent achievements include the effective rollout of SFO in April 2003, introduction of amendments to the Red Book concerning corporate governance and the Code of Corporate Governance Practices in January 2004, and the release by the Standing Committee on Company Law Reform of its Final Recommendations on Phase II Corporate Governance Review in the same month.

- 1.13 On the accounting front, a Private Member's Bill had just been introduced into the Legislative Council on 24 March 2004, which will enhance the regulatory regime of the accounting profession. In addition, we shall shortly announce consultation conclusions on the way forward for the setting up of an Independent Investigation Board and a Financial Reporting Review Panel.
- 1.14 We shall continue to work with the regulators, the market and the legislature in upgrading our corporate governance standards to sharpen our competitive edge in the international market.

## **CHAPTER 2 – STATUTORY BACKING FOR LISTING REQUIREMENTS**

### **OVERWHELMING SUPPORT FOR STATUTORY BACKING**

- 2.1 As discussed in paragraph 1.5, there is an overwhelming support from the market as well as the general public for giving listing requirements statutory backing.
- 2.2 In the Consultation Paper on Proposals to Enhance the Regulation of Listing (the Consultation Paper), we have already discussed the advantages of giving statutory backing to the more important listing requirements. These are recapitulated below -
- (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;
  - (c) to enable the imposition of a wide 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; and
  - (d) to bring our regulatory regime into line with international standards and practices.
- 2.3 Apart from these substantive advantages, the signaling effect cannot be ignored. The introduction of statutory listing requirements would demonstrate to the market, listed issuers and prospective listing applicants alike, our commitment to enhancing market quality. By the same token, inaction or delayed actions would send a wrong signal to market users, and undermine the competitiveness of our equity market.
- 2.4 We recognise that public views, in particular those of the investing public, as to what constitutes the more important listing requirements will evolve over time in tandem with market needs and international



trends. We are glad to note from this consultation exercise that a general consensus on this subject has evolved, which we will discuss in the following sections.

## **EXISTING ARRANGEMENTS**

2.5 As mentioned in the Consultation Paper, the dual filing system introduced under the Securities and Futures (Stock Market Listing) Rules (SFSMLR) made by SFC on 1 April 2003 is, to a limited extent, a way of granting statutory backing to certain fundamental listing requirements (*c.f.* paragraph 2.10 of the Consultation Paper). The SFSMLR already contains provisions prescribing the requirements for listing applications, including disclosure at initial public offerings (IPOs). Specifically, Rule 3(c) stipulates that a listing application should “contain such particulars and information which, having regard to the particular nature of the applicant and the securities, is necessary to enable an investor to make an informed assessment of the activities, assets and liabilities and financial position, of the applicant at the time of the application and its profits and losses and of the rights attaching to the securities.” Whether the existing provisions in SFSMLR are adequate in regulating listing applications would be a subject for regular review and refinement by SFC in light both of market development and any need to synchronise with the recommended statutory listing regime set out in the rest of this Chapter and in Chapter 3.

2.6 However, SFSMLR does not explicitly provide for similar requirements for ongoing disclosure materials. In the absence of a positive obligation on listed companies to disclose information, SFSMLR does not address cases of non-disclosure, late disclosure or selective disclosure of price-sensitive or relevant information after a company is listed (*c.f.* paragraph 2.15 of the Consultation Paper). The effectiveness of the present dual filing system in dealing with ongoing disclosure is therefore limited, despite the importance of quality post-IPO disclosure in enabling investors to make informed decisions.

## **POSSIBLE CANDIDATES FOR STATUTORY BACKING**

- 2.7 Based on public comments received, we have identified the following categories of listing requirements to which priority should be accorded for the purpose of giving statutory backing, in addition to those provided for in SFSMLR –
- (a) financial reporting and other periodic disclosure by listed companies;
  - (b) disclosure of price-sensitive information by listed companies; and
  - (c) shareholders' approval for certain notifiable transactions.
- 2.8 We will elaborate on these categories of listing requirements and the “primary targets” responsible for meeting these requirements in the ensuing paragraphs.

### **Financial reporting and other periodic disclosure**

- 2.9 There is an overwhelming support for giving statutory backing to listing requirements governing financial reporting and other periodic disclosure by listed companies. These include the requirements for a listed company to produce at specific times certain documents which have to be made available to the holders of its securities and the public. These documents include annual reports (i.e. directors' report, annual accounts and auditors' report), interim reports and preliminary announcements of results, etc.
- 2.10 Under the existing Red Book, the requirements concerning financial reporting and other periodic disclosure by listed companies are set out mainly in Chapter 4, Appendices 7 (which is the Listing Agreement), 15 and 16. Major requirements include –
- (a) general obligation to provide financial statements which give a true and fair view of the state of affairs of the listed company;
  - (b) basic financial information to be included, e.g. income statement, balance sheet, and segment information;

- (c) information to be included in annual reports, e.g. particulars of certain transactions of the listed company in its securities, or securities of its subsidiaries;
- (d) information to be included in interim reports, e.g. balance sheet, income statement, and cash flow statement;
- (e) how disclosure should be made to holders of its securities and the public; and
- (f) when the disclosure has to be made.

2.11 In giving this category of listing requirements statutory backing, we recommend imposing in the statute the obligations to provide **full, timely and accurate** financial reports and other periodic disclosure, including those mentioned in paragraph 2.10 above. This can be achieved by codifying the obligations in the statute, governing –

- (a) the types of documents required to be prepared and disclosed;
- (b) the content requirements of documents referred to in (a) above; and
- (c) the timing for disclosing the documents referred to in (a) above.

### **Disclosure of price-sensitive information**

2.12 Apart from financial reporting and other periodic disclosure by listed companies, many submissions point out that it is important to impose statutory obligations on issuers to disclose price-sensitive information in a timely manner. This may include the issuer's obligation under paragraph 2 of the Listing Agreement to keep the Exchange, members of the issuer and other holders of its listed securities informed as soon as reasonably practicable of any information relating to the group (including information on any major new developments in the group's sphere of activities which is not public knowledge) which –

- (a) is necessary to enable members of the issuer and other holders of its listed securities and the public to appraise the position of the group;

- (b) is necessary to avoid the creation of a false market in its securities; and
- (c) which might be reasonably expected materially to affect market activity in and the price of its securities.

2.13 We recognise that there may be circumstances where the obligation to disclose as soon as reasonably practicable price-sensitive information could not be fulfilled by an issuer due to confidentiality or commercial sensitivity. Accordingly, we recommend that “safe harbour” rules be made to exempt compliance with this obligation under certain circumstances. We will further elaborate on “safe harbour” rules in paragraphs 2.17 and 2.18 below. (Please also see paragraphs 3.8 and 3.9(b) on means of making these “safe harbour” rules in the statute.)

#### **Shareholders’ approval for certain notifiable transactions<sup>10</sup>**

2.14 During the consultation exercise, many submissions point out that those listing requirements which relate to shareholders’ protection should be given priority for statutory backing. Accordingly, they support requirements concerning the need for shareholders’ approval for certain notifiable transactions being included in the statute. This category differs from the two categories mentioned in paragraphs 2.9 to 2.13 above as it is not directly related to disclosure. It is more concerned with the mechanism of protecting minority shareholders against possible abuses and expropriation by insiders on a general basis.

2.15 Under the Red Book, prior shareholders’ approval for some major transactions, such as very substantial disposal, very substantial acquisition, and connected transactions of a larger size, is required under certain circumstances. In addition, shareholders deemed to be “interested” persons are not permitted to vote. There are also requirements on the procedures for obtaining shareholders’ approval.

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<sup>10</sup> Under the Red Book, issuers have to disclose details of notifiable transactions to SEHK and inform shareholders of such transactions. These transactions include share transactions; discloseable transactions; major transactions; very substantial disposal and acquisition; reverse takeover and connected transactions.

2.16 According to some market comments, these transactions, due to their size, are sufficiently material to warrant regulation by statute. HKEx points out to us that requirements for shareholders' approval for these transactions could secure for shareholders, in particular minority shareholders, adequate opportunity to consider in advance and vote upon major changes in the company's business operations or matters of importance concerning the activities of insiders (including management and significant shareholders). This enhancement of shareholder rights acts as a check on ill-considered transactions; the misappropriation of company assets; and abuse of powers by directors and other insiders to benefit themselves. Statutory backing will provide a further deterrence against abuse in this area of governance and should contribute to an increase in investor confidence in the regulatory regime.

### **“SAFE HARBOUR” RULES**

2.17 We are mindful of the need to avoid either outlawing legitimate commercial activities or over-regulation lest it may stifle market development. Accordingly, we recommend that SFC be empowered to make “safe harbour” rules under s.36 of SFO to exempt certain categories of corporate or market activities from compliance with statutory listing requirements. Such “safe harbour” rules made by SFC will be subsidiary legislation subject to negative vetting by the Legislative Council. The making of these rules would be subject to public consultation before the rules are tabled before the Legislative Council. This arrangement is in line with the making of “safe harbour” rules by SFC under Parts XIII and XIV of SFO to exempt certain market activities from the market misconduct regime, and the making of case exemptions and class exemptions (in the form of subsidiary legislation) by SFC to exempt compliance with certain provisions under Parts II and XII of the Companies Ordinance.

2.18 One example that has been suggested is to empower SFC to make “safe harbour” rules to exempt the application of the requirement for disclosing price-sensitive information under certain conditions. These may include circumstances where disclosure is likely to seriously prejudice the company's legitimate interests; or the director reasonably believes that the relevant information is confidential and the director has ensured that reasonable precautions are in place to preserve the confidentiality of the relevant information until the

relevant information is disclosed to the market.

## **OTHER LISTING REQUIREMENTS**

- 2.19 From the submissions received, there are divergent views as to whether the existing listing requirements concerning disclosure of notifiable transactions and announcement of specific events<sup>11</sup> should be given statutory backing.
- 2.20 Some submissions indicate that since the disclosure requirements concerning notifiable transactions often involve discretionary judgement by SEHK of the merits of individual cases, it would be difficult to codify them in the law without unduly constraining interpretation. Some consider that vesting SFC with a great deal of discretionary power in interpreting and enforcing statutory provisions would result in uncertainty. Some express doubt as to whether breaches of requirements on announcement of specific events should warrant civil or even criminal sanctions as if it were a type of market misconduct. (Please also see Chapter 3 on extending the market misconduct regime under SFO.)
- 2.21 Given the lack of general consensus on whether to include these listing requirements in the statute, we recommend adopting a phased approach. In **Phase I**, priority should be given to preparing statutory rules on the more important listing requirements discussed above, including financial reporting and other periodic disclosure by listed companies, disclosure of price-sensitive information by listed companies, and shareholders' approval for certain notifiable transactions. To tie in with these new rules and the introduction of sanctions (to be discussed in Chapter 3), SFC may also conduct a review of the requirements for listing applications introduced via SFSMLR in light of its regulatory experience since their introduction in April 2003. In **Phase II**, the Government, SFC and HKEx should together review the need to extend the scope of these statutory provisions to cover other listing requirements, in light of the regulatory experience gained from Phase I, public reaction and market development needs.

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<sup>11</sup> Under the Red Book, issuers have to make public announcements upon certain events, such as change in auditors, appointment or resignation of a director, bankruptcy and receivership, etc.

## “PRIMARY TARGETS”

- 2.22 We are advised by SFC and HKEx that for the regulatory regime to be effective, proportionate sanctions should be imposed directly on issuers, directors and corporate officers<sup>12</sup> against any breaches of the statutory listing requirements. They consider that in addition to issuers, directors and corporate officers should be made the “primary targets”.<sup>13</sup> SFC and HKEx agree that these two types of persons are company insiders with a sufficient degree of participation in corporate decision-making and can reasonably be held responsible for disclosure made by the company.
- 2.23 Whether the scope of “primary targets” should be expanded would be reviewed as and when necessary in light of the regulatory experience gained from Phase I, public reaction and market developments.
- 2.24 We have not included sponsors into the group of “primary targets” for the purpose of the Consultation Conclusions, as we recognise that sponsors are regulated by SFC under the licensing regime enshrined in SFO. Under SFO, sponsors are required to have a licence to carry out Type 6 regulated activity, i.e. advising on corporate finance.<sup>14</sup> Before granting a licence, SFC has to be satisfied that the applicant is a fit and proper person for the regulated activity. Once a licence is granted, the licensee is required to remain fit and proper at all times and to comply with the codes and guidelines issued by SFC. If a licensed sponsor is found to have committed a misconduct, or found not to be fit and proper to be, or remain the same type of regulated person, SFC may take disciplinary action against him, ranging from

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<sup>12</sup> According to Schedule 1 to SFO, “officer” (高級人員), in relation to a corporation, means a director, manager or secretary of, or any other person involved in the management of, the corporation.

<sup>13</sup> Under the Red Book, the SEHK Listing Committee may impose sanctions on eight categories of persons/entities for breaching the provisions in the Red Book, namely: (a) a listed issuer or any of its subsidiaries; (b) any director of a listed issuer or any of its subsidiaries or any alternate of such director; (c) any member of the senior management of a listed issuer or any of its subsidiaries; (d) any substantial shareholder of a listed issuer; (e) any professional adviser of a listed issuer or any of its subsidiaries; (f) any sponsor of a listed issuer or a new applicant; (g) any authorised representative of a listed issuer; and (h) any supervisor of a PRC issuer. The “primary targets” for the purpose of the Consultation Conclusions have been built on (a), (b), (c) and (g) above.

<sup>14</sup> Under Schedule 5 to SFO, there are totally nine types of regulated activities. Type 6 activity refers to giving advice concerning, amongst others, an offer to dispose of securities to the public. This requires all IPO sponsors to be licensed by SFC before they may offer services to sponsor an IPO on SEHK.

private or public reprimands, a fine of up to \$10 million, to suspension or revocation of his licence.

- 2.25 We shall rely on the regulatory framework under SFO, in particular the licensing regime, for SFC to regulate sponsors. We believe that the regulatory regime for intermediaries enshrined in SFO has already empowered SFC to set standards, investigate into misconduct and impose disciplinary sanctions on sponsors effectively. We note the efforts being currently made by SFC and HKEx to upgrade the regulation of sponsors. We recommend that SFC and HKEx should expedite their action on this front with a view to securing early implementation of improvement measures.

## **ENFORCEMENT AUTHORITY**

- 2.26 As mentioned in the Consultation Paper, ‘statutorily backed rules will be more effectively enforced by a statutory entity.’ As a market operator and a subsidiary of a listed company, SEHK does not have the investigative powers of a law enforcement agency, such as SFC, necessary 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 to SFC for more effective investigation and sanctions” (*c.f.* paragraph 3.17 of the Consultation Paper). The submissions received have confirmed the public’s agreement with this view.
- 2.27 In light of market views, statutory listing requirements will continue to be enforced by SFC, similar to the existing arrangement for SFSMLR made under s.36 of SFO. With the experience accumulated under the dual filing system since April 2003, the market generally recognises that SFC is well-placed to enforce statutory listing requirements. Together with the fact that SFC has already been vested with the necessary powers to investigate into suspected corporate misconduct under SFO, the arrangement for SFC to enforce any new statutory listing requirements would require minimal changes to the law. This would facilitate early implementation of the improvement measures proposed in the Consultation Conclusions. We shall discuss this further in Chapter 3.



2.28 On the other hand, the expertise of HKEx, as a for-profit entity, lies in the operation of exchanges, and promotion of its services and products to potential users, especially those brought about by new business opportunities offered by economic growth in the Mainland and the increasing demand for capital by Mainland issuers. Enforcement of statutory rules may divert its resources from its mainstream business development.

## **CHAPTER 3 – REGULATORY STRUCTURE**

### **EXPANDING THE DUAL FILING SYSTEM**

- 3.1 As mentioned in paragraph 1.7, the submissions received generally support expanding the dual filing system, referred to as Model D in the Consultation Paper. At the same time, we note that a few submissions have indicated a preference for the transfer of listing functions to SFC. Our assessment is that it would be pre-mature to introduce any drastic structural reform at this stage.
- 3.2 Many submissions mention that the dual filing system, which increases the level of SFC's involvement in regulating corporate disclosure, has been effective. They prefer to allow the dual filing system to evolve and expand instead of embarking on a major structural reform at this stage. In fact, as discussed in paragraph 1.5, many submissions point out that the crux of the problem of the present regulatory regime lies with the lack of effective sanctions to deter non-compliance with the Red Book. In this context, the most pressing task ahead would be to introduce statutory backing to the more important listing requirements. The public will be in a better position to consider the desirability of any structural change in the regulatory regime in light of the experience in implementing the new statutory listing requirements.
- 3.3 Under Model D, HKEx will remain responsible for administering the listing process. This is in line with the present arrangement under the dual filing system as set out in the Memorandum of Understanding (MOU) Governing Listing Matters signed between SFC and SEHK in January 2003. HKEx will continue to receive IPO applications at the frontline. Listing applications are first reviewed by the Listing Unit of the Exchange. In considering a listing application, HKEx will assess whether all the relevant qualifications for listing have been met by a listing applicant on the basis of the prospectus and the submissions provided in support of the listing application. Where necessary, the Listing Unit asks questions about such information, obtains additional assurance from relevant professional advisers and seeks additional disclosure in the prospectus, if appropriate. The SEHK Listing Committee then considers the application. No companies shall be listed on SEHK unless their applications for listing

have been approved by the SEHK Listing Committee, which has the power to approve or reject applications and to impose further conditions for listing where appropriate.

- 3.4 SFC will be able to take regulatory actions under the statute including objection to listing, or direct SEHK to suspend dealings in securities, or cancel the listing of any securities. It may also exercise statutory enforcement powers where it has reasons to believe that there are breaches of statutory listing requirements. SFC may act, either on its own volition, or on HKEx's referral.

## **MEANS OF PROVIDING STATUTORY LISTING REQUIREMENTS**

### **Why subsidiary legislation**

- 3.5 We note that many submissions, while lending support for giving the more important listing requirements statutory backing, express concerns that these statutory requirements may lack flexibility. "Flexibility" involves the following elements –
- (a) the ability to amend the statutory listing requirements in a timely and efficient manner; and
  - (b) the possibility of exempting certain types of activities from the application of these statutory requirements under specified circumstances.
- 3.6 On paragraph 3.5(a), as discussed in the Consultation Paper, the legislative process of making and amending subsidiary legislation is, generally speaking, simpler than that for primary legislation. It would not be constrained by the legislative timetable for amending primary law, which only allows for a limited number of bills in each legislative session. The making of and amendments to subsidiary legislation, on the other hand, are subject only to negative vetting by the legislature. This procedure would normally take seven weeks and is thus shorter than a full-blown legislative process.
- 3.7 Under the current s.36 of SFO, SFC may make rules to prescribe statutory listing requirements after consulting SEHK and the Financial Secretary (FS) (see **Annex B** for provisions of s.36 of SFO). Before

making such rules, SFC has the statutory duty under s.398 of SFO to publish draft rules for public consultation. (Detailed requirements are set out in s.398(1), (2) and (3) of SFO at **Annex C**). The rules made by SFC are subsidiary legislation subject to negative vetting by the Legislative Council. This rule-making process may not be lengthier than that for amending the Red Book. As some submissions have rightly pointed out, the SEHK, in amending its Red Book, has to go through the due process of market consultation, consultation with the SEHK Listing Committee and, finally, seeking approval from SFC.

3.8 On paragraph 3.5(b), we are mindful of the need to ensure that legislation governing listing matters can evolve in tandem with market developments and innovations, while allowing sufficient flexibility for the market to remain attractive to users. Hence, we recommend that SFC be empowered to make “safe harbour” rules to exempt compliance with certain statutory listing requirements under specific circumstances.

3.9 In light of the existing legislative framework governing the equity market as laid down in SFO, we recommend giving the more important listing requirements statutory backing through a mix of primary and subsidiary legislation, supplemented with codes and guidelines. This can be achieved by the following –

- (a) **Primary legislation:** the Government will amend SFO to extend the market misconduct regime in Parts XIII and XIV of SFO to cover breaches of listing requirements stipulated in the current SFSMLR and any new statutory rules to be made by SFC under s.36 of SFO. This in effect will make a breach of statutory listing requirements a new type of market misconduct under SFO, as discussed in paragraphs 3.16 – 3.24 below. In addition, to address calls for swift action, the Government will also amend SFO to empower SFC to impose civil sanctions, namely reprimands and disqualification orders, on the “primary targets” (as identified in paragraph 2.22).

- (b) **Subsidiary legislation:** SFC will make statutory rules under s.36 of SFO to codify the more important listing requirements (as discussed in Chapter 2). Also, SFC will make “safe harbour” rules under s.36 of SFO to exempt compliance with certain statutory listing requirements to facilitate market development and innovation.
- (c) **Non-statutory codes and guidelines:** SFC will introduce codes and guidelines under s. 399 of SFO to provide guidance in relation to the operation of the statutory listing requirements in the subsidiary legislation to assist compliance. These are not part of the legislation but could provide users with helpful guidance.

### **Deeming the Red Book as statute?**

- 3.10 Some submissions have proposed to give the Red Book statutory backing without turning the Red Book itself into legislation. One possibility, as put forward by some submissions, would be for SFC to impose a general obligation on issuers to disclose important information to investors in a timely manner, and non-compliance with the Red Book could be taken into consideration by SFC in determining whether an issuer had complied with the statutory disclosure duties. It has been argued that such an arrangement could enable the statutory regulator to apply sanctions on breaches of the Red Book, while preserving the non-statutory status, and hence flexibility, of the Red Book.
- 3.11 Under the proposal mentioned in the preceding paragraph, the Red Book which would not be part of the legislation does not have any legal binding force. The Red Book can only be issued to provide guidance for compliance. Judicial or other proceedings cannot be brought against a person purely on the basis that he fails to comply with the Red Book. The Red Book could be admissible in evidence in any proceedings under SFO and be taken into account if it appears to the court to be relevant. But the Red Book would merely have evidential value; it will not be turned into statutory rules, and cannot be directly enforced.

3.12 For achieving similar policy objectives, the Government had, in 1999, contemplated a proposal for giving the Red Book statutory backing when drafting SFO. Very briefly, the proposal then aimed to empower SFC to apply to the court for orders to -

- (a) compel compliance with the Red Book. Non-compliance with the order would have constituted a contempt of court, and the court might at its discretion have imposed appropriate sanctions on those in breach; and/or
- (b) disqualify a director of a listed company, who had wilfully or persistently failed to discharge his duties under the Red Book, from being a director of any listed company for a period of time.

3.13 The market, at that time, responded by noting that any proposal to give statutory backing to the Red Book should not come at the cost of rendering its application unduly legalistic. In particular, the market stressed the need to retain flexibility so that it might evolve in keeping with market developments and innovations. In light of these market sentiments, the Government sought extensive legal advice in developing the proposal. The advice it received confirmed that, if the proposal of conferring statutory backing onto the Red Book were implemented, and SFC were to be empowered to enforce compliance with the Red Book, the latter would have the status of law, and its content would effectively become statutory provisions. The Red Book would thus have become subject to normal rules of legislative interpretation and procedures for amendment and would have lost the flexibility and expeditious interpretation that were considered to be so vital for the market. In view of the foregoing, we decided not to pursue the 1999 proposal to provide statutory backing to the Red Book on a wholesale basis.

3.14 We see both the merit as well as the need to go through the normal legislative process before we introduce any statutory sanctions for breaches of the more important listing requirements. Instead of pursuing the 1999 proposal, we now recommend adopting a targeted approach, focusing on the more important listing requirements and turning them into legislation to facilitate enforcement and promote compliance, while preserving the rest as they are, that is, as non-statutory requirements in the Red Book to allow for more flexible

application. Breaches of the statutory listing requirements would be treated as market misconduct, attracting civil or criminal sanctions. This would significantly affect the statutory liabilities of the parties concerned, notably issuers, directors and corporate officers. In view of the far reaching implications, it would be necessary to go through the proper legislative process, including prior public consultation and negative vetting by the Legislative Council. This would be in line with the existing arrangement for SFC making other types of statutory rules under SFO.

- 3.15 In codifying the more important listing requirements in subsidiary legislation, we are mindful of the need for SFC to strike a reasonable balance between clarity and flexibility as to what these requirements are and how they will be enforced. We expect that the rules to be made by SFC under s.36 of SFO would give the market sufficient details as to the clarity and certainty of the nature of relevant listing requirements. This is important as a breach of these requirements, unlike a breach of the Red Book today, may bring about serious consequences, including the possibility of civil and criminal sanctions, as discussed in paragraphs 3.16 – 3.35 below. SFC could then supplement these statutory rules with non-statutory codes and guidelines, which could adopt a market-friendly style and be easily updated to reflect market trends and meet user needs. A breach of these codes and guidelines itself will not be treated as a breach of the law, but will be taken into account by SFC in considering whether the statutory listing requirements have been complied with and hence the need for possible enforcement action. This is similar to the operation of SFC’s licensing requirements under SFO.<sup>15</sup>

## **EXTENDING THE MARKET MISCONDUCT REGIME UNDER SFO**

- 3.16 We recommend extending the market misconduct regime under Parts XIII and XIV of SFO to cover breaches of statutory listing requirements made by SFC under s.36 of SFO, including relevant

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<sup>15</sup> For instance, s.129 of SFO sets out fundamental “fit and proper” criteria in the licensing regime for market intermediaries. These include financial status, qualifications, experience, ability, reputation, character, reliability and financial integrity. The subsidiary legislation, e.g. the Securities and Futures (Licensing and Registration) (Information) Rules, sets out the detailed requirements. To explain how such rules operate, SFC has promulgated three licensing guidelines, namely “Fit and Proper Guidelines”, “Guidelines on Competence” and “Guidelines on Continuous Professional Training” for market practitioners’ reference.

provisions in the current SFSMLR and the new statutory listing requirements to be made by SFC. Breaching statutory listing requirements would become a new type of market misconduct, subject to the same dual civil and criminal treatment as the other six types of market misconduct<sup>16</sup> stipulated in SFO.

- 3.17 As mentioned in paragraph 3.7, s.36 of SFO already empowers SFC to make statutory rules to govern listing after consulting SEHK, FS and the public as required by s.398 of SFO. These statutory rules may prescribe the requirements to be met before securities may be listed and the procedure for dealing with applications for the listing of securities, and may provide for cancellation of the listing of any specified securities.
- 3.18 Following enactment of SFO in March 2002, SFC promulgated SFSMLR pursuant to s.36 of SFO to provide for the dual filing system. Under SFSMLR, SFC may object to the listing if the disclosure in the listing documents is false or misleading. It may also direct SEHK to suspend dealings in securities, or cancel the listing of any securities under certain circumstances. However, SFO does not provide for any statutory sanctions, nor does it empower SFC to provide sanctions, for breaches of the statutory listing rules made by SFC. The dual filing system relies on criminal sanctions available under s.384<sup>17</sup> of SFO for intentional or reckless provision of false or misleading information to SFC. The market generally considers this inadequate.
- 3.19 Extending the market misconduct regime to cover breaches of statutory listing requirements would subject all breaches of statutory listing requirements to civil or criminal sanctions. The current market misconduct regime as provided for in Parts XIII and XIV of SFO provides for a dual regime, i.e. parallel civil and criminal regimes, to deter market misconduct. Should breaches of statutory listing requirements be included as a new type of market misconduct,

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<sup>16</sup> These are insider dealing, stock market manipulation, false trading in securities or futures contracts, price rigging in securities or futures markets, disclosure of information about prohibited transactions in securities or futures contracts, and disclosure of false or misleading information inducing transactions in securities or futures contracts.

<sup>17</sup> On the ambit of s.384 of SFO, SFC has expressed doubt as to whether that section of the Ordinance could deal with omissions. Legal advice indicates that generally speaking, intentional or reckless provision of misleading information by way of omission of material information could be prosecuted under s.384 of SFO. That said, the Government is prepared to consider legislative amendments to put it beyond doubt that s.384 would deal with intentional or reckless omission of information.



SFC would, following investigation, have the power to refer reports on investigation into such breaches to the Secretary for Justice (SJ) for considering criminal prosecution under Part XIV, or to notify FS for consideration as to whether civil proceedings before the Market Misconduct Tribunal (MMT) under Part XIII should be instituted. In addition, SFC may institute in its own name summary criminal proceedings before a Magistrate.

3.20 The MMT may impose a range of civil sanctions under s. 257 of SFO, including –

- (a) disgorgement of profits made or loss avoided, subject to compound interest thereon;
- (b) disqualification of a person from being a director or otherwise involved in the management of a listed company for up to five years;
- (c) a “cold shoulder” order on a person (i.e. the person is deprived of access to market facilities) for up to five years;
- (d) a “cease and desist” order (i.e. an order not to breach any of the market misconduct provisions in Part XIII of SFO again);
- (e) a recommendation order that the person be disciplined by any body of which that person is a member; and
- (f) payment of the costs of the MMT inquiry and/or SFC investigation.

3.21 For offences tried under the criminal route under Part XIV of SFO, the maximum penalties the court could impose are fines of \$10 million and 10 years’ imprisonment.

3.22 We have received a number of submissions stating that serious breaches of statutory listing requirements, especially those involving fraudulent or deceitful intent, or harm to the public interest, should be subject to criminal sanctions. We recognise that any breach of statutory listing requirements would not only result in harm to securities holders and potential investors, but also tarnish the reputation of our equity market as a whole. Hence, we share the

market view that any **intentional** breaches of the statutory listing requirements should warrant criminal sanctions, such as heavy financial penalties and imprisonment as these have a stronger deterrent effect.

- 3.23 On the other hand, we are also mindful of the need to avoid subjecting unintentional or inadvertent breaches to criminal proceedings and sanctions. In extending the criminal market misconduct regime in Part XIV of SFO to cover breaches of statutory listing requirements, we will ensure that all the necessary safeguards, including the defences and *mens rea* tests that have been established in Part XIV of SFO, would also apply to breaches of statutory listing requirements.
- 3.24 There is no double jeopardy of MMT inquiry under Part XIII and criminal prosecution under Part XIV of SFO. A person who has been acquitted or convicted of an offence under Part XIV cannot be made the 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. The same will apply to a breach of statutory listing requirements in future.

### **DIRECT CIVIL SANCTIONS BY SFC AGAINST THE “PRIMARY TARGETS”<sup>18</sup>**

- 3.25 Some submissions call for a wider range of regulatory tools which would enable SFC to take timely actions against breaches. We agree that the availability of direct sanctions by SFC, targeting at specific, well-defined groups of persons/entities, would supplement the market misconduct regime. It would allow SFC to impose direct civil sanctions against breaches of the statutory listing requirements, without having to go through civil hearing by an MMT under Part XIII of SFO, or criminal prosecution under Part XIV of SFO. The targetted groups of persons/entities may include issuers, directors and corporate officers. These basically constitute the “primary targets”, who are primarily accountable for corporate disclosure and other corporate activities, as advised by SFC and HKEx (see paragraph 2.22).

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<sup>18</sup> “Primary targets” refer to issuers, directors and corporate officers. See paragraph 2.22.

3.26 Legal advice confirmed that both reprimands and disqualification orders are civil sanctions. In other words, these sanctions can be administered by a regulator such as SFC, with the proceedings for establishing the breach of statutory listing requirements remaining civil for human rights purposes.

3.27 Having taken into account relevant considerations including the legal advice given, we recommend that SFC be empowered to impose the following civil sanctions directly on “primary targets” –

(a) Reprimands

SFC may be empowered to issue reprimands to the “primary targets” i.e. issuers, directors and corporate officers that are not licensed by SFC.

(b) Disqualification orders

SFC may be empowered to impose disqualification orders on the “primary targets” i.e. directors and corporate officers for breaches of statutory listing requirements. A disqualification order would debar a person from being a director or manager of a listed company for a period not exceeding five years<sup>19</sup>. This would enable SFC to deal with breaches of the relevant listing requirements relatively swiftly and effectively, thereby sending a clear signal to the market that certain behaviour jeopardising investors’ interest would not be tolerated or condoned.

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<sup>19</sup> Prior to the commencement of SFO on 1 April 2003, insider dealing cases are handled by the Insider Dealing Tribunal (“IDT”) under Securities (Insider Dealing) Ordinance (“SIDO”) which was repealed with the commencement of SFO. Both MMT under SFO and IDT under SIDO may make disqualification orders. Since the establishment of IDT in 1991, IDT had made disqualification orders ranging from 6 months to 4 years.

- 3.28 We will consider how SFO should be amended to achieve this, subject to procedural safeguards for fair hearing that are in line with those presently provided for under Part IX of SFO for discipline of licensed intermediaries and those involved in their management. Reprimands and disqualification orders issued by SFC would be appealable to the Securities and Futures Appeals Tribunal (SFAT)<sup>20</sup>. This could provide effective checks and balances to ensure proper use of powers by SFC. Other safeguards are shortlisted at **Annex D** for reference.
- 3.29 We believe that the above civil sanctions to be imposed directly by SFC should be confined to specific, well-defined “primary targets” i.e. those groups of persons/entities who are primarily responsible for ensuring compliance with the listing requirements. This will have to be codified clearly in SFO as appropriate. However, for the time being, we do not see a strong case to empower SFC to discipline directly persons other than these specific, well-defined “primary targets”. Nevertheless, relevant parties other than the “primary targets” would still be subject to the dual civil and criminal route for combating market misconduct set out in paragraphs 3.19 to 3.21 above. Whether the scope of “primary targets” should be expanded would be reviewed as and when necessary as mentioned in paragraph 2.23.

### **A THREE-PRONGED APPROACH**

- 3.30 In the meantime, we believe a three-pronged approach will provide the possibility of an appropriate range of sanctions for misconduct by any party. The first prong, described above, involves direct SFC discipline of “primary targets”. For the reasons set out in paragraph 3.29 above, we do not believe it would be tenable to extend this direct disciplinary regime to persons/entities other than the specific, well-defined “primary targets” i.e. issuers, directors and corporate officers. Instead, where (a) other relevant parties such as substantial shareholders of a listed issuer or professional advisers are suspected of having breached the statutory listing requirements, and/or (b) the

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<sup>20</sup> SFAT is a statutory tribunal with a jurisdiction to review specified decisions as set out in Schedule 8 to SFO. Major categories of appealable decisions include authorisation of automated trading services and related matters; authorisation of collective investment scheme/advertisements and related matters; granting of licence/registration and related matters; imposition of disciplinary sanctions; exercise of intervention power; determination of investor compensation; and listing related matters.

direct disciplinary regime by SFC is inadequate, SFC may refer such cases to SJ who will decide whether to bring criminal prosecution under Part XIV of SFO (i.e. the criminal route). If SJ takes the view that prosecution is not justified, FS may be advised to consider a third option, i.e. instituting civil proceedings before the MMT under Part XIII of SFO (i.e. the civil route).

- 3.31 The market misconduct regime, unlike SFC's direct disciplinary regime, deals with breaches by **any persons** and may impose a wider range of sanctions. We recognise that this regime may not be able to deal with suspected breaches as quickly as the administration of direct civil sanctions by SFC but its coverage is broader, both in terms of implicated persons and types of sanctions. However, in view of the fact that issuers, directors and corporate officers are principally responsible for corporate disclosure and other corporate activities, we believe our proposal for a three-pronged regime to deal with breaches of statutory listing requirements (i.e. SFC's limited but direct civil sanctions on the specific, well-defined "primary targets"; a broad range of civil sanctions by MMT against all relevant persons under Part XIII of SFO; or criminal prosecution under Part XIV of SFO against all relevant persons) is appropriate.
- 3.32 As mentioned in paragraph 3.24, the current SFO already contains provisions to ensure that there is no double jeopardy of MMT enquiry under Part XIII and criminal prosecution under Part XIV. In respect of SFC's power to impose direct civil sanctions as proposed in paragraph 3.27 above, legal advice indicates that SFC's civil sanctions would not pre-empt an MMT enquiry or prosecution under Part XIV of SFO, and vice versa.
- 3.33 In fact, such a three-pronged approach is not novel. Under the current regime under Parts IX, XIII and XIV of SFO, should an SFC licensee be suspected of a market misconduct, SFC may take disciplinary actions such as reprimand, suspension and revocation of a licence under Part IX of SFO. This is **in addition to** referral to SJ for her to consider criminal prosecution under Part XIV or for SJ to notify FS for his consideration of whether MMT proceedings under Part XIII should be instituted. Similar arrangements could be adopted for dealing with breaches of statutory listing requirements to allow greater flexibility in enforcement and create proportionate deterrents. That is, an issuer, a director or a corporate officer (i.e. the

“primary targets”) found in breach of a statutory listing requirement might be subject to -

- (a) a direct reprimand or disqualification order by SFC, as appropriate; and
- (b) (i) civil sanctions imposed by MMT; or  
 (ii) criminal sanctions up to \$10 million fine and 10 years’ imprisonment imposed by the court, if the intention could be proved beyond reasonable doubt.

Persons other than these specific, well-defined “primary targets” who commit a breach of the statutory listing requirements would be subject to the sanctions in (b) only.

3.34 Sanctions by SFC under paragraph 3.33(a) are appealable to SFAT; sanctions by MMT to the Court of Appeal.

3.35 Our recommendations for the sanctions and appeal mechanism for a person who breaches the statutory listing requirements under the three-pronged approach are summarised as follows -

	<b>Sanctions</b>	<b>Persons to be sanctioned</b>	<b>Appeals to</b>
SFC	<b>Civil</b> <ul style="list-style-type: none"> <li>• reprimands</li> <li>• disqualification orders</li> </ul>	Specific, well-defined “primary targets” – <ul style="list-style-type: none"> <li>• issuers (reprimands only);</li> <li>• directors; and</li> <li>• corporate officers.</li> </ul>	SFAT

	<b>Sanctions</b>	<b>Persons to be sanctioned</b>	<b>Appeals to</b>
MMT	<p><b><u>Civil</u></b></p> <ul style="list-style-type: none"> <li>• disgorgement of profit or loss avoided</li> <li>• disqualification order</li> <li>• “cold shoulder” order</li> <li>• “cease and desist” order</li> <li>• recommendation order for discipline by professional bodies</li> <li>• payment for MMT’s enquiry costs and/or SFC’s investigation costs</li> </ul>	Any person who engages in market misconduct including, but not limited to, the “primary targets”.	Court of Appeal
Court of First Instance	<p><b><u>Criminal</u></b></p> <ul style="list-style-type: none"> <li>• fine of up to \$10 million</li> <li>• imprisonment up to 10 years</li> </ul>	Any person who intentionally engages in market misconduct including, but not limited to, the “primary targets”.	Court of Appeal

(A person who has breached a statutory listing requirement may also be liable for having knowingly or recklessly provided false or misleading information to SFC under the current dual filing system and may be subject to a fine of up to \$1 million and imprisonment for up to 2 years under s.384 of SFO.)

## **ARE CIVIL FINES POSSIBLE?**

- 3.36 Some submissions suggest that SFC should be empowered to impose financial penalties on persons who are found to have breached the statutory listing requirements. It is argued that this would give the regulator an effective and flexible tool to deter breaches of statutory listing requirements. We recognise that empowering the regulator to impose financial penalties has the advantage of enabling the regulator to deal with breaches directly and swiftly, provided that the penalties are substantial for them to be effective in deterring misconduct in the listed sector. However, as pointed out in the Consultation Paper, substantial financial penalties that go beyond their compensatory function, may turn the regulatory regime into a criminal one for human rights purposes and hence require the incorporation of all safeguards necessary for a fair hearing in a criminal regime.<sup>21</sup>
- 3.37 We have further explored the alternative means of empowering SFC to impose financial penalties on the above specific, well-defined “primary targets” i.e. the issuers, directors as well as corporate officers, without being in breach of the relevant fair hearing requirement provided for under the human rights provisions of the Basic Law. Legal advice obtained indicates that, in the absence of full disciplinary relationship between SFC and the “primary targets” similar to one that exists between SFC and the licensed brokers, under which the SFC may suspend or revoke their licence, the imposition of financial penalties by SFC on those entities/persons is likely to change the proposed regulatory regime into a criminal one for human rights purposes, thus necessitating the presence of procedural safeguards for criminal proceedings and defeating the purpose of swift penalties.
- 3.38 Moving forward, we would explore whether MMT could be empowered to impose financial penalties, as a new type of sanctions, on well-defined groups of persons/entities for breaching certain statutory listing requirements made by SFC.

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<sup>21</sup> Paragraph 2.42 of the Consultation Paper states that “..... 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.”



## **CHAPTER 4 – ADMINISTRATIVE MEASURES TO IMPROVE THE LISTING REGIME**

### **TRANSPARENCY AND ACCOUNTABILITY OF THE PERFORMANCE OF LISTING FUNCTIONS**

4.1 Some submissions express concern about the transparency and accountability of the listing regime. In this chapter we shall set out the major concerns, and recommend specific improvement measures.

#### **Transparency**

4.2 Some submissions point out that there is a lack of transparency in the operation of the listing regime. They are not clear as to how HKEx's Listing Unit presents cases to the SEHK Listing Committee, and they neither have access to decisions made by the SEHK Listing Committee nor the reasons for such decisions. We have enquired with both SFC and HKEx and set out their response in paragraphs 4.3 to 4.5 below.

4.3 Due to its confidentiality obligations, HKEx advises us that it does not publish decisions or the reasons for its decisions in such a way that any of the parties concerned could be identified. To achieve greater transparency regarding its interpretation of specific requirements, HKEx at present publishes on-line written guidance as "Listing Decisions". These comprise decisions on a selection of cases handled by the SEHK Listing Committee and the Listing Unit on an anonymous basis. HKEx also publishes in its quarterly newsletter "Exchange" both "Listing Decisions", and "Compliance Decisions" which comprise recent sanctions of a public nature.

4.4 HKEx further advises us that with regard to its communication with listing applicants/listed issuers, the Listing Unit will normally explain to them and their advisers its approach to presenting their cases to the SEHK Listing Committee. It is HKEx's current practice that once an application or other matter has been heard by the SEHK Listing Committee, it will prepare a decision letter which sets out details of those members present in the hearing and their collective decisions on the case in question. On receipt of this letter, a listing

applicant/listed issuer has the opportunity to request the SEHK Listing Committee to give written reasons for decisions made to the extent that the rationale is not already evident from the decision letter.

- 4.5 SFC is at the receiving end of statutory filing of listing documents by listing applicants and ongoing disclosure materials by listed companies under the dual filing system. We learn from SFC that it issues press releases once every two to three months to report on the number of listing applications reviewed and commented on, as well as the more notable disclosure problems which it has identified.
- 4.6 We agree that the publication of listing-related decisions made by SFC and HKEx is beneficial to the market as it can enhance transparency and market understanding of the considerations of the regulators. It can also facilitate those listing applicants and issuers which wish to seek a review of the decisions made by SFC and the SEHK Listing Committee with the relevant appeal bodies, i.e. SFAT in the case of decisions made by SFC, and the SEHK Listing Appeals Committee in relation to decisions made by the SEHK Listing Committee.
- 4.7 To address the market concerns about transparency, we have invited SFC and HKEx to consider how disclosure of regulatory decisions concerning listing could be enhanced, without compromising confidentiality. We are delighted to note that the HKEx Executive contemplates the following measures to enhance transparency -
- (a) with immediate effect to increase the number of listing decisions to be published;
  - (b) in the short term to establish a practice of publishing, on a regular basis, interpretations made by the Listing Unit of provisions in the Red Book; and
  - (c) in the longer term to explore the possibility of -
    - (i) establishing a “help-desk” facility to answer general enquiries on interpretation and application of the provisions in the Red Book; and
    - (ii) communicating more clearly the standards and behaviour that HKEx expects of listed issuers and their directors by,

for instance, reviewing the form and structure of the provisions in the Red Book.

- 4.8 We also understand that SFC would, on top of the existing transparency measures mentioned in paragraph 4.5 above, publish in its regular press releases the grounds on which a listing application is rejected without identifying the applicant, which would add to the general guidance given in its press briefings which are held twice a year. SFC believes that this would enhance transparency and market understanding.
- 4.9 We welcome the above constructive initiatives made by the SFC and HKEx Executive, and look forward to their early implementation where appropriate.

### **Accountability**

- 4.10 Some submissions point out that the accountability of SFC and HKEx in their performance of listing functions is not entirely clear. Some comment that there is confusion over the division of responsibilities between the two regulators. Some note that there is no document clarifying the respective powers and responsibilities of the two regulators.
- 4.11 To clarify the delineation of responsibilities between SFC and HKEx in administering the listing functions, they entered into the MOU Governing Listing Matters in January 2003 which sets out, amongst others, their division of responsibilities and the detailed procedures for handling the listing documents and ongoing disclosure materials filed with these two regulators. The MOU is a public document which can be found at the websites of SFC and HKEx at [www.hksfc.org.hk](http://www.hksfc.org.hk) and [www.hkex.com.hk](http://www.hkex.com.hk) respectively.
- 4.12 Notwithstanding this, we recognise that there are merits in enhancing public understanding about the respective roles and duties of SFC and HKEx in the performance of listing functions. We believe that this could be achieved by –
- (a) a public statement by SFC and HKEx setting out in simple and clear terms their functions and responsibilities, and coordination

between the two regulators in respect of sharing of information in respect of listing; and

- (b) publication of review reports that can assist the public in assessing the ongoing performance of listing functions by HKEx, as well as SFC's regulatory oversight of HKEx in this regard.

4.13 We have invited SFC and HKEx to consider the proposal in paragraph 4.12(a), regarding their division of responsibilities for listing, both as at present and upon the expansion of the dual filing system. On paragraph 4.12(b), we believe that the publication of review reports could build on the existing mechanism for SFC to audit the performance of listing functions by HKEx. This is discussed further in ensuing paragraphs.

#### **Annual audit of listing functions**

4.14 Some submissions suggest that SFC should conduct an annual review of the performance of HKEx's Listing Unit, and that the review reports should be published to enhance transparency. This would strengthen SFC's regulatory oversight of HKEx, and enhance the transparency and accountability of HKEx in performing its listing functions. In fact, the MOU Governing Listing Matters signed in January 2003 has already set out the requirement for SFC to conduct audits or reviews of SEHK's performance in its regulation of listing-related matters at 18 months interval (clauses 10.4 and 10.5 of the MOU).

4.15 Building on the existing administrative arrangement for SFC to conduct regular audit reviews on HKEx's performance of listing functions, we recommend that SFC prepare and submit annual reports on these audits to FS, who shall cause the reports to be published. Through the publication of such annual review reports, to the extent permitted within the constraints of secrecy and confidentiality, the public will be better able to judge HKEx's performance of the listing functions, as well as SFC's performance in overseeing and supervising HKEx's performance of listing-related functions.

4.16 The specific areas or subjects that may come under the audit review, and the methodology to be adopted, would be a subject for further discussion between SFC and HKEx. Nevertheless, we believe the

audit should cover –

- (a) amendments to and administration of the Red Book;
- (b) adequacy of funding and staffing;
- (c) handling of listing applications and cases involving ongoing compliance;
- (d) handling of disciplinary cases and expeditiousness in taking disciplinary actions; and
- (e) problems encountered and remedial actions taken.

4.17 We are pleased to note the positive response from HKEx Executive, who proposes that the audit review may cover the effectiveness, efficiency and fairness of the operation of the Listing Unit. The areas that may be covered by the review as contemplated by the HKEx Executive are as follows –

- (a) assessment of the adequacy, both quantity and quality, of the staff and other resources deployed by HKEx to discharge its listing regulatory functions;
- (b) arrangements for the declaration and handling of conflict of interests;
- (c) handling of confidential information;
- (d) handling of complaints against issuers, their directors and advisers;
- (e) handling of complaints against the Listing Unit and the SEHK Listing Committee;
- (f) monitoring of disclosure of price-sensitive information - press and media monitoring and price monitoring;
- (g) handling of suspensions;
- (h) obligations under dual filing;
- (i) review of listing applications and prospectus vetting;

- (j) review of significant transactions;
- (k) co-operation, co-ordination and the exchange of information with other regulators;
- (l) review of disciplinary processes;
- (m) handling of review cases;
- (n) handling of pre-IPO enquiries;
- (o) handling of requests for direction and clarification of the provisions in the Red Book; and
- (p) review of financial reports, etc.

4.18 We welcome HKEx Executive's positive response to the recommendation of publishing reports on the audit review conducted by SFC of the Exchange's performance of the listing functions, and its suggestion on areas for review. These would form a useful basis for further discussion between SFC and HKEx.

4.19 To ensure procedural fairness and reasonableness in conducting the audit review, SFC's regulatory oversight of HKEx's performance of listing functions, including the conduct of annual audits, can be a subject of regular review by the Process Review Panel (PRP) for SFC.<sup>22</sup>

## **Conflict of interests?**

### ***Existing safeguards***

4.20 As pointed out in the Consultation Paper, there already exist a multitude of checks and balances to address any real or perceived conflict of interests between HKEx's regulatory role and its listed company status (*c.f.* paragraph 3.11 of the Consultation Paper). They include –

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<sup>22</sup> Process Review Panel for SFC is an independent, non-statutory panel established by the Chief Executive to conduct review of SFC's operational procedures to ensure that the procedures are fair and reasonable, and to determine if, in handling cases or taking actions or making decisions, SFC has followed its internal due process procedures.

- (a) statutory safeguards as provided for under SFO<sup>23</sup> – 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 (MOUs) 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.

4.21 Most of the submissions consider that there is no evidence demonstrating that the existing safeguards are either inadequate or not working. Some submissions state that the independent SEHK Listing Committee is an adequate safeguard against any conflict of interests. It appears from the submissions received that, from the market users’ point of views, any conflict of interests is perceived rather than real.

4.22 Apart from the checks and balances mentioned in paragraph 4.20 above, SFO also provides a mechanism for dealing with situations where a conflict may arise or has arisen. Under s.75 of SFO<sup>24</sup>, where SFC is satisfied that a conflict exists or may come into existence between the interest of HKEx and the interest of the proper performance of HKEx’s statutory functions; or such a conflict of interests has existed in circumstances that make it likely that the conflict of interests will continue or be repeated, the Commission may direct HKEx to remedy the situation. Thus far, since SFC was first vested with this power in February 2000, SFC has not given any such direction.

### ***Common interest***

4.23 In fact, HKEx’s business success hinges on the quality of its products,

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<sup>23</sup> 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.

<sup>24</sup> Section 75 of SFO replicates section 14 of the Exchanges and Clearing Houses (Merger) Ordinance which came into effect in February 2000 and had been repealed after SFO came into operation on 1 April 2003.

including the quality of companies listed on its exchanges. Market quality is essential to its branding and can increase the attractiveness of the market to issuers and investors. As far as HKEx is concerned, this can only be achieved by effective enforcement of the requirements set out in the Red Book. Therefore, there is in practice a strong commercial incentive for HKEx to fulfil its obligations arising from its role in enforcing the Red Book.

- 4.24 Separately, there have been questions as to whether HKEx, as a commercial entity, may have the incentive to take rigorous enforcement actions against breaches of the requirements in the Red Book. Some point to the fact that the sanctions imposed on breaches such as reprimands are too light to achieve the deterrent effect. However, as discussed in paragraph 1.6, the lack of effective sanctions is the natural consequence of the non-statutory status of the Red Book. The fact that the sanctions imposed by HKEx may not have a strong deterrent effect does not stem from any perceived or real conflict of interests on the part of HKEx, but rather the lack of teeth of the Red Book itself.
- 4.25 Although most submissions consider that any conflict of interests on the part of HKEx is perceived rather than real, we should strive to improve the listing regime to avoid any perceived or real conflict of interests at both the corporate and staff levels. This would reinforce market users' confidence in the regulatory regime.
- 4.26 A regulator stakes its credibility on, amongst other things, the application of rules in a consistent and transparent manner. It should act, and be seen to be acting, fairly and independently. With its considerable experience in dealing with listing matters, HKEx has already developed practices and procedures to put in place effective internal control measures to ensure the professionalism and integrity of its staff. However, to further enhance market users' confidence, we believe that a management review by an independent party would be helpful in refining the current regime.

### ***Study by the Independent Commission Against Corruption***

- 4.27 In this context, we recommend HKEx and SFC to invite the Independent Commission Against Corruption (ICAC) to study procedures and practices for the performance of listing-related



functions from the point of view of corruption prevention, and other related issues, such as building in checks and balances in their internal control systems. Under the ICAC Ordinance, the Commissioner of the ICAC has the duty to, amongst others, examine the practices and procedures of public bodies and advise heads of public bodies of changes in practices or procedures compatible with the effective discharge of their duties. Both SFC and HKEx are public bodies under the Prevention of Bribery Ordinance. ICAC has, in the past, conducted studies for both organisations in areas such as procurement, and SFC's licensing and enforcement regimes. In the context of listing, ICAC's assessment of the effectiveness of the existing checks and balances at both the corporate (e.g. "Chinese wall" between HKEx's regulatory and business units) and the staff levels, as well as recommendations for improvement, would be helpful in removing any lingering doubt about the impartiality and independence of HKEx's Listing Unit (including the SEHK Listing Committee).

- 4.28 Like HKEx, SFC is involved in vetting listing and ongoing disclosure documents under the dual filing system. The SFSMLR provides that a listing applicant and an issuer should file a copy of the application and ongoing disclosure materials respectively with SFC. The MOU Governing Listing Matters signed in January 2003 also sets out the procedures for sharing listing documents and ongoing disclosure materials as well as the regulators' comments. Given that both SFC and HKEx have their roles to play under the dual filing system, it would be logical and necessary for ICAC to review the procedures or processes of SFC's Dual Filing Team concurrently.
- 4.29 We have invited both SFC and HKEx to cooperate with ICAC for the proposed study to be conducted in the second half of 2004. We believe that the study and its recommendations would help strengthen the integrity and credibility of their regulatory regimes. Should ICAC identify any improvement measures, we recommend that the implementation of these measures be regularly monitored through the following established mechanisms –
- (a) SFC's annual audits of HKEx's Listing Unit (*c.f.* paragraphs 4.15 – 4.17 above); and
  - (b) annual reports of PRP for SFC on SFC's due process (*c.f.* paragraph 4.19 above).

## SEHK LISTING COMMITTEE

- 4.30 Many submissions complement members of the SEHK Listing Committee for bringing market knowledge and professional expertise to bear on the listing process. Some submissions also mention the SEHK Listing Committee as an additional measure to ensure the independence of the listing functions and decisions from HKEx's business activities.
- 4.31 On the other hand, we have also received a number of suggestions for improving the operation of the SEHK Listing Committee, the most notable one being to expand the membership of the SEHK Listing Committee<sup>25</sup> to include more representatives of the investing public. Some submissions have also indicated concern about the increasing workload of SEHK Listing Committee members arising from the processing of cases as well as the consideration of policy matters relating to the Red Book. Remedial measures that have been suggested include allocating sufficient resources to the Listing Unit to provide more effective support for the SEHK Listing Committee, and providing the SEHK Listing Committee with access to professional advice or input from outside in a way similar to the provision of professional service and advice to company directors.
- 4.32 There are also comments that the SEHK Listing Committee be restructured to enhance operational efficiency. One suggestion is that separate SEHK Listing Committee, Listing Policy and Appeals Committee and Disciplinary Appeals Committee be set up. These committees will be responsible for making decisions on listing applications, handling appeals against listing decisions and considering policy matters, and handling appeals against disciplinary decisions respectively.
- 4.33 There are also comments that it is important to avoid possible conflict of interests on the part of individual SEHK Listing Committee members so that the listing process could be, and is seen to be, done in a fair and independent manner. In addition, there is suggestion that there be some form of documentation which clearly defines the roles,

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<sup>25</sup> The existing membership of the SEHK Listing Committee comprises Exchange participants, listed company representatives, market practitioners and users (including fund managers, lawyers and accountants, etc.) and one ex-officio member (the Chief Executive of HKEx).

powers and responsibilities of the SEHK Listing Committee, its chairman or its members, and their relationship with staff of the Listing Unit.

- 4.34 We have invited SFC and HKEx to consider whether, and if so, how, the above suggestions concerning the composition and operation of the SEHK Listing Committee, and secretariat support for the SEHK Listing Committee, should be pursued.

## **REFERRAL OF OTHER MEASURES TO SFC AND HKEX**

4.35 Some submissions have put forward suggestions for improving the operation of SFC and HKEx in respect of listing matters. Major proposals are summarised below –

- (a) The various MOUs between SFC and HKEx (and SEHK in some cases) could be consolidated into one single document to better clarify the respective roles of the two regulators.<sup>26</sup>
- (b) An electronic disclosure database containing all documents filed by listing applicants and ongoing disclosure materials filed by listed issuers with SFC and/or HKEx could be set up. Such materials could be made available for on-line access by investors at the same time as the relevant information is released to the public. This arrangement would ensure transparency for all disclosure documents and allow investors all over the world ready access to such information.
- (c) Since the majority of companies listed in Hong Kong are incorporated overseas, SFC could consider developing bilateral arrangements with the relevant authorities in the jurisdictions where listed companies are incorporated for more effective enforcement.
- (d) While there is much support for the retention of the SEHK Listing Committee to preserve market savvy, there are

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<sup>26</sup> There are three MOUs between SFC and HKEx (and SEHK in some cases) which are currently in force, namely the MOU Governing Listing Matters, MOU for the Listing of HKEx on SEHK, and MOU on Matters Relating to SFC Oversight, Supervision of Exchange Participants and Market Surveillance. SFC and HKEx may consider the feasibility and desirability of consolidating these MOUs.

suggestions to improve the operation of the SEHK Listing Committee. Please see paragraphs 4.31 – 4.33 above for details.

We have invited SFC to give favourable consideration to these suggestions and decide whether, and if so, how they could be taken forward.

## **CHAPTER 5 – RECOMMENDATIONS AND IMPLEMENTATION ROADMAP**

- 5.1 Hong Kong has successfully developed into a major international financial centre, and has established itself as the pre-eminent venue of choice for leading Mainland enterprises wishing to tap the international capital markets. We have also successfully attracted a pool of world class professionals, with international exposure in the financial sector, who provide quality intermediary services. However, past achievement does not guarantee future success. We must strive to enhance the quality and hence the reputation of our market to take advantage of the rapid expansion and opening up of the Mainland market amidst increasing competition from other markets.
- 5.2. In a rapidly globalising economy, it is vital that we benchmark ourselves against other international financial centres and keep our legal and regulatory framework under regular review for timely improvement. As discussed in the Consultation Paper as well as Chapter 2 of the Consultation Conclusions, it has become an international trend for listed companies to be regulated through statutorily-backed rules. Therefore, by giving the more important listing requirements statutory backing, or more “teeth”, we can upgrade our regulatory regime in respect of listing in line with international standards. Prompt action is required to prevent our market from lagging behind.
- 5.3 Giving the more important listing requirements statutory backing would undoubtedly benefit the investing public by deterring certain types of corporate misconduct that harm shareholders, including false and misleading disclosure, non-disclosure and late disclosure. And the gains would not be confined to investors – issuers would certainly benefit from increased liquidity arising from enhanced investor confidence. Improvement in the quality and hence reputation of our market would also help bring in more quality listings, from which our intermediaries could benefit.

## SUMMARY OF RECOMMENDATIONS

5.4 In view of general public support for giving statutory backing to the more important listing requirements, and expanding the dual filing system, we make the recommendations summarised in ensuing paragraphs.

### To improve the regulatory structure

- (1) To give the more important listing requirements statutory backing (paragraphs 2.1 – 2.4 and 3.9)

We recommend that the more important listing requirements should be given statutory backing. This would be achieved through a mix of primary and subsidiary legislation, supplemented with codes and guidelines -

- (a) **Primary legislation:** the Government will amend SFO to extend the market misconduct regime in Parts XIII and XIV of SFO to cover breaches of listing requirements stipulated in the current SFSMLR and any new statutory rules to be made by SFC under s. 36 of SFO. In addition, to address calls for swift action, the Government will also amend SFO to empower SFC to impose civil sanctions, namely reprimands and disqualification orders, on “primary targets”. (See recommendations 7 and 8 below.)
- (b) **Subsidiary legislation:** SFC will make statutory rules under s.36 of SFO to codify the more important listing requirements in the statute. Also, SFC will make “safe harbour” rules under s. 36 of SFO to exempt compliance with certain statutory listing requirements to facilitate market development and innovation. (See recommendations 2 and 3 below.)
- (c) **Non-statutory codes and guidelines:** SFC will introduce codes and guidelines under s.399 of SFO to provide guidance in relation to the operation of the statutory requirements in the subsidiary legislation to assist

compliance. They are not part of the legislation but could provide users with helpful guidance.

- (2) Categories of listing requirements to be statutorily backed in addition to those provided for under SFSMLR (paragraphs 2.7 – 2.16) –
  - (a) financial reporting and other periodic disclosure by listed companies (paragraphs 2.9 to 2.11);
  - (b) disclosure of price-sensitive information by listed companies (paragraphs 2.12 to 2.13); and
  - (c) shareholders’ approval for certain notifiable transactions (paragraphs 2.14 to 2.16).
- (3) To empower SFC to make “safe harbour” rules to exempt compliance with statutory listing requirements (paragraphs 2.17 and 2.18)

To avoid either outlawing legitimate commercial activities or over-regulation lest it may stifle market development, we recommend that SFC be empowered to make “safe harbour” rules under s.36 of SFO. These rules will exempt certain categories of corporate or market activities from compliance with statutory listing requirements. The making of these rules would be subject to public consultation and negative vetting by the Legislative Council.

- (4) To adopt a phased approach in preparing statutory listing requirements (paragraph 2.21)

In **Phase I**, priority should be given to preparing statutory rules on the more important listing requirements mentioned in recommendation 2 above. These should tie in with the preparation of the Securities and Futures (Amendment) Bill referred to in recommendation (1)(a) above, in order to allow the public and the legislature a better understanding of the total package of legislative changes.

In **Phase II**, the Government, SFC and HKEx should together review the need to extend the scope of statutory provisions to cover other listing requirements in light of the regulatory experience gained from Phase I, public reaction and market development needs.

- (5) To continue to entrust SFC with enforcement of statutory listing requirements (paragraphs 2.26 – 2.27)

We recommend that statutory listing requirements should continue to be enforced by SFC, similar to the existing arrangement for SFSMLR made under s.36 of SFO.

- (6) To expand the dual filing system (paragraphs 3.1 – 3.4)

We recommend expanding the existing dual filing system. HKEx will remain responsible for administering the listing process and continue to receive IPO applications at the frontline. No securities will be listed on SEHK unless they are approved by the SEHK Listing Committee. SFC would detect and investigate into any non-compliance with the statutory listing requirements, and assess whether it should exercise its statutory power to object to a listing application.

As for ongoing compliance of listed companies, the same division of labour between SFC and HKEx would apply i.e. SFC would be responsible for enforcing existing and new statutory listing requirements, while HKEx would continue to enforce the non-statutory requirements in the Red Book. SFC will be able to exercise statutory enforcement powers where it has reasons to believe that there are breaches of statutory listing requirements.

### **To introduce more effective sanctions**

- (7) To extend the market misconduct regime to cover breaches of statutory listing requirements (paragraphs 3.16 – 3.24)

We recommend extending the market misconduct regime under Parts XIII and XIV of SFO to **any person** who breaches



statutory listing requirements so that he/she would be subject to civil sanctions by MMT under Part XIII of SFO, or criminal prosecution under Part XIV of SFO.

In extending the criminal market misconduct regime to cover breaches of statutory listing requirements, we will ensure that all the necessary safeguards, including the defences and *mens rea* tests that have been established in Part XIV of SFO, would also apply to breaches of statutory listing requirements.

- (8) To empower SFC to impose direct civil sanctions on “primary targets” (paragraphs 3.25 – 3.29)

We recommend empowering SFC to impose direct civil sanctions, namely reprimands and disqualification orders as appropriate, against breaches of the statutory listing requirements by the specific, well-defined “primary targets”, viz. issuers, directors and corporate officers. In preparing these Consultation Conclusions, SFC and HKEx agree that directors and corporate officers are company insiders with a sufficient degree of participation in corporate decision making and can reasonably be held responsible for disclosure made by the company. This would enable SFC to deal with breaches relatively swiftly and effectively. These SFC’s decisions would be subject to appeal to the Securities and Futures Appeals Tribunal.

- (9) SFC and HKEx to expedite action to upgrade regulation of sponsors (paragraph 2.25)

We believe that the regulatory regime for intermediaries enshrined in SFO has already empowered SFC to set the standards, investigate into misconduct and impose disciplinary sanctions on sponsors effectively. We shall rely on the regulatory framework under SFO, in particular the licensing regime, for SFC to regulate sponsors. We note the efforts being made by SFC and HKEx in this regard since their joint consultation in May 2003. We recommend that SFC and HKEx should expedite their action on this front with a view to securing early implementation of improvement measures.

(10) To introduce a three-pronged regime to deal with breaches of statutory listing requirements (paragraphs 3.30 – 3.35)

By extending the market misconduct regime to any persons and empowering SFC to impose direct civil sanctions on the “primary targets” against breaches of statutory listing requirements, we are proposing a three-pronged regime to provide effective deterrents against these breaches as follows –

	<b>Types of Sanctions</b>	<b>Persons to be sanctioned</b>	<b>Appeals to</b>
SFC	<b>Civil</b> <ul style="list-style-type: none"> <li>• reprimands</li> <li>• disqualification orders</li> </ul>	Specific, well-defined “primary targets” – <ul style="list-style-type: none"> <li>• issuers (reprimands only)</li> <li>• directors</li> <li>• corporate officers</li> </ul>	SFAT
MMT	<b>Civil</b> <ul style="list-style-type: none"> <li>• disgorgement of profit or loss avoided</li> <li>• disqualification order</li> <li>• “cold shoulder” order</li> <li>• “cease and desist” order</li> <li>• recommendation order for discipline by professional bodies</li> </ul>	Any person who engages in market misconduct including, but not limited to, the “primary targets” .	Court of Appeal

	<b>Types of Sanctions</b>	<b>Persons to be sanctioned</b>	<b>Appeals to</b>
	<ul style="list-style-type: none"> <li>• payment for MMT's enquiry costs and/or SFC's investigation costs</li> </ul>		
Court of First Instance	<p><b>Criminal</b></p> <ul style="list-style-type: none"> <li>• fine of up to \$10 million</li> <li>• imprisonment up to 10 years</li> </ul>	Any person who intentionally engages in market misconduct including, but not limited to, the "primary targets".	Court of Appeal

(A person who has breached a statutory listing requirement may also be liable for having knowingly or recklessly provided false or misleading information to SFC under the current dual filing system and may be subject to a fine of up to \$1 million and imprisonment for up to 2 years under s.384 of SFO.)

### **To enhance transparency and accountability of the performance of listing functions**

- (11) SFC and HKEx to implement improvement measures to enhance the transparency of their decisions relating to listing (paragraphs 4.7 – 4.8)

We have invited SFC and HKEx to consider how disclosure of regulatory decisions concerning listing could be made to enhance transparency and market understanding of the considerations of the regulators. We are delighted to note that HKEx Executive contemplates the following measures to enhance transparency –

- (a) with immediate effect, increasing the number of listing decisions to be published;
- (b) in the short term, establishing a practice of publishing, on a regular basis, interpretations made by the Listing Unit of provisions in the Red Book; and
- (c) in the longer term, exploring the possibility of -
  - establishing a “help-desk” facility to answer general enquiries on interpretation and application of the provisions in the Red Book; and
  - communicating more clearly the standards and behaviour that HKEx expects of listed issuers and their directors by, for instance, reviewing the form and structure of the provisions in the Red Book.

We also note that SFC would publish in their regular press releases the grounds on which a listing application is rejected without identifying the applicant, which would add to the general guidance given in their press briefings which are held twice a year.

- (12) SFC and HKEx to articulate in a public statement their division of responsibilities relating to listing (paragraphs 4.12 – 4.13)

We have invited SFC and HKEx to consider the proposal for articulating in a public statement, in clear and simple terms, their division of responsibilities relating to listing, both as at present and upon the expansion of the dual filing system. This will enhance public understanding about the respective roles and duties of SFC and HKEx in the performance of listing functions.

- (13) SFC to submit its reports on annual audit of HKEx’s performance of listing functions to FS who shall cause the reports to be published (paragraphs 4.15 – 4.17)

Building on the existing administrative arrangement for SFC to conduct regular audit reviews on HKEx’s performance of listing functions, we recommend that SFC prepare and submit

annual reports on these audits to FS, who shall cause the reports to be published. Through the publication of such annual review reports, to the extent permitted within the constraints of secrecy and confidentiality, the public will be better able to judge HKEx's performance of the listing functions, as well as SFC's performance in overseeing and supervising HKEx's performance of listing-related functions.

The specific areas or subjects that may come under the audit review, and the methodology to be adopted, would be a subject for further discussion between SFC and HKEx. We believe the audit should cover -

- (a) amendments to and administration of the Red Book;
  - (b) adequacy of funding and staffing;
  - (c) handling of listing applications and cases involving ongoing compliance;
  - (d) handling of disciplinary cases and expeditiousness in taking disciplinary actions; and
  - (e) problems encountered and remedial actions taken.
- (14) SFC's regulatory oversight of HKEx's performance of listing functions to be a subject of review by the PRP for SFC (paragraph 4.19)

To ensure procedural fairness and reasonableness in conducting the audit review, we recommend that SFC's regulatory oversight of HKEx's performance of listing functions, including the conduct of annual audits, be a subject of regular review by PRP for SFC.

### **Concern about any conflict of interests**

- (15) To invite ICAC to study procedures and practices for the performance of listing-related functions by SFC and HKEx (paragraphs 4.27 – 4.28)

We recommend SFC and HKEx to invite ICAC to study their respective procedures and practices for the performance of

listing functions under the dual filing system from the point of view of corruption prevention, and other related issues, such as building in effective checks and balances in their internal control systems.

- (16) To monitor regularly the implementation of improvement measures identified by ICAC's study in recommendation 15 above (paragraph 4.29)

We recommend that the implementation of improvement measures identified by ICAC, if any, be regularly monitored through the following established mechanisms -

- (a) SFC's annual audits of HKEx's Listing Unit; and
- (b) annual reports of PRP for SFC on SFC's due process.

## **ROADMAP FOR IMPLEMENTING THE IMPROVEMENT MEASURES**

5.5 The Government is committed to improving the listing regime. Prompt actions on the part of the Government, SFC and HKEx are required to meet the needs of the rapidly changing market. Most submissions echo the sense of urgency for improving the regulatory regime governing listing. With this in mind, we have set out the following timeframe for implementing the improvement measures recommended in the Consultation Conclusions.

### **Giving statutory backing to the more important listing requirements**

5.6 The Government will commence drafting a Securities and Futures (Amendment) Bill. This is expected to include the extension of the market misconduct regime to cover breaches of statutory listing requirements, and provisions relating to civil sanctions to be imposed by SFC on such breaches. We have invited SFC to commence concurrently the preparation of Rules under s.36 of SFO to codify the more important listing requirements in statute by phases. We aim to introduce the Amendment Bill into the Legislative Council in early 2005. To facilitate consideration of the Amendment Bill by the legislature and the public, we have invited SFC to expose the draft s.36 Rules for Phase I for public consultation before the Amendment Bill is introduced into the Legislative Council.

Legislative Measures	Target Timeframe
<p>1. Introduction of a Securities and Futures (Amendment) Bill by the Government</p> <ul style="list-style-type: none"> <li>• Public consultation</li> <li>• Introduction to the Legislative Council</li> </ul> <p>2. Making of s.36 Rules by SFC by phases</p> <ul style="list-style-type: none"> <li>• Exposure of draft s.36 Rules for Phase I for public consultation</li> <li>• Laying Amendment Rules for Phase I before the Legislative Council for negative vetting</li> </ul>	<ul style="list-style-type: none"> <li>• Q4 2004</li> <li>• Q1 2005</li> </ul> <ul style="list-style-type: none"> <li>• Q4 2004</li> <li>• Once the Securities and Futures (Amendment) Bill is enacted</li> </ul>

**Administrative measures to enhance transparency and accountability**

5.7 We look forward to support by both SFC and HKEx for early implementation of the administrative measures to enhance the transparency and accountability of the listing regime set out in Chapter 4 of the Consultation Conclusions. The following implementation timetable represents the preliminary assessment of the parties concerned, including SFC and HKEx Executive.

<b>Administrative Measures</b>	<b>Target Timeframe</b>
<p>1. ICAC's study on procedures and practices for the performance of listing functions</p> <ul style="list-style-type: none"> <li>• Completion of study</li> <li>• Implementation of recommendations for improvement</li> </ul> <p>2. Implementation of measures to enhance the transparency of listing decisions by SFC and HKEx</p> <p>3. SFC's annual audits of HKEx's performance of listing functions</p> <ul style="list-style-type: none"> <li>• Submission of first report by SFC to FS and publication of the first audit report by FS</li> </ul> <p>4. PRP for SFC's annual reports on SFC's regulatory oversight of HKEx's listing functions</p> <ul style="list-style-type: none"> <li>• Publication of 2004 PRP report by FS</li> </ul>	<ul style="list-style-type: none"> <li>• By end 2004</li> <li>• By Q4 2005</li> </ul> <ul style="list-style-type: none"> <li>• By phases – Phase I: By 2004 Phase II: By 2005</li> </ul> <ul style="list-style-type: none"> <li>• By Q2 2005</li> </ul> <ul style="list-style-type: none"> <li>• By Q2 2005</li> </ul>



# ANNEXES

## **SUMMARY OF SUBMISSIONS**

1. We have received 48 submissions from individuals, corporations, professional associations, trade bodies and regulators. A list of the submissions is at the end of this Annex.

### **Statutory Backing for Listing Requirements**

#### *Overview*

2. The majority of submissions support statutory backing being given to certain listing requirements. Only a few do not support statutory backing, or are silent on this proposal.
3. Many submissions indicate that there is a need for more effective sanctions for breaches of the Red Book, and that statutory backing for listing requirements is the best way to achieve this. Statutory backing will encourage compliance by issuers as any breaches in respect of these requirements will be subject to statutory sanctions. It will also result in more effective enforcement of listing requirements and better corporate governance.

#### *Candidates for statutory backing*

4. Submissions which support statutory backing contain suggestions on possible candidates for statutory backing. The most frequently raised candidates are –
  - (a) financial reporting and other periodic disclosure;
  - (b) disclosure of price-sensitive information;
  - (c) shareholders' approval for certain notifiable transactions; and
  - (d) disclosure of notifiable transactions, e.g. connected and substantial transactions.

### ***How to give statutory backing***

5. Most submissions support giving statutory backing through a balanced mix of primary and subsidiary legislation, with some suggesting promulgation of non-statutory codes and guidelines to further elaborate the application of statutory provisions. This approach is considered by many as striking a reasonable balance between enforceability and flexibility.
6. Some submissions note that SFC currently has the power under s. 36 of the Securities and Futures Ordinance (SFO) to make statutory listing rules. Building on the existing SFO framework, they suggest that statutory backing to certain listing requirements be achieved by enshrining them in the rules to be made under s.36.
7. There is a suggestion that statutory backing could be given to listing requirements without including them in the statute. This is done by imposing in the law –
  - (a) a general obligation on issuers to disclose important information (on an ongoing basis) to investors in a timely fashion;
  - (b) an obligation on issuers' directors to ensure that their companies comply with the disclosure obligation in (a) above; and
  - (c) sanctions on breaches of the statutory disclosure obligation in (a) above.

The disclosure requirements will remain in the Red Book or contained in codes issued by SFC, and non-compliance with these requirements could be taken into consideration by SFC in determining whether an issuer and its directors have complied with the statutory disclosure duty.

8. The majority who support statutory backing consider that it should be SFC, the regulator under the existing SFO framework, to enforce statutory listing requirements.

### ***Sanctions for breaches of statutory listing requirements***

9. Many submissions support civil sanctions, e.g. civil fines, disgorgement orders, disqualification orders, to be imposed on

breaches of statutory listing requirements. There is suggestion that the existing types and levels of civil sanctions available to the Market Misconduct Tribunal under Part XIII of SFO should also be applicable to breaches of statutory listing requirements. Some consider that severe breaches of certain fundamental listing requirements (in particular intentional or reckless breaches) should be administered under the criminal regime, although a few cast doubts on the deterrent effect of criminal sanctions given the difficulty in securing criminal conviction.

10. Some propose that statutory sanctions should be imposed by the court or an independent tribunal such as the Market Misconduct Tribunal, and not by SFC. At the same time, there are a few others suggesting SFC be given the power to impose sanctions on people who breach statutory listing requirements.

### **Regulatory Structure<sup>27</sup>**

11. There is general support for expanding the dual filing system (i.e. Model D as described in the Consultation Paper).
12. Those submissions which support Model D consider that the system has been running smoothly since its introduction on 1 April 2003. They argue that expanding the dual filing system will cause the least disruption to the regulatory structure, and that it is also more prudent to improve on the existing system than introduce radical changes to the regulatory structure. It is expected that Model D will not impose any additional burden or cost on those issuers which fully comply with the listing requirements. Others consider that Model D will avoid over-concentration of power in a single regulator. Some suggest that under this Model, SFC should only be involved in dealing with more serious and material breaches of listing requirements.
13. Those submissions which support Model A consider that this would minimise overlapping of work and allow greater synergy within SFC

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<sup>27</sup> Four alternative models of regulatory structure are proposed in Chapter 3 of the Consultation Paper on Proposals to Enhance the Regulation of Listing published on 3 October 2003. The four models are –  
Model A: Listing functions transferred to SFC;  
Model B: Listing functions transferred to HKEx subsidiary;  
Model C: Listing functions transferred to independent statutory authority; and  
Model D: Expanding “dual filing” system.

as its various regulatory functions will complement each other. There are views that the dual filing system increases the costs borne by the market and of raising capital by issuers since both SFC and HKEx are involved in prospectus vetting. With the two teams reviewing each prospectus, nobody has clear responsibility for failure. Transferring listing functions to SFC will create a sole accountable and independent regulator. Some submissions also consider that Model A could eliminate any real or perceived conflict of interests on the part of HKEx.

14. Many submissions consider that the existing safeguards are adequate to guard against actual or perceived conflict of interests between HKEx's role as the primary regulator of entry to the equity market and its status as a for-profit listed company. They do not see the need to introduce further substantive structural safeguards. Some point out that there is no evidence demonstrating a real conflict of interests exists and that conflict of interests is perceived rather than real. A few submissions however say that HKEx has conflict of interests. They consider that the statutory safeguards provided for under SFO have no real effect as it is difficult to prove to the court that HKEx has failed to perform its statutory duty to act in the interest of the public. Some believe that such conflict could only be eliminated by structural changes, e.g. by adopting Model A.

## **Other Remarks**

### ***Transparency and accountability***

15. Some submissions suggest that SFC should conduct annual audits and continuous reviews of HKEx's performance of listing functions. Some of them further recommend reports on these audits/reviews should be published to enhance transparency.
16. Some submissions comment that the existing operation of SEHK Listing Committee and HKEx's Listing Unit is in a "black box" and there is a need to enhance the transparency of their operation, especially on how cases are presented to the SEHK Listing Committee, its decisions and the reasons for such decisions. Greater transparency regarding their work may enhance public confidence.

17. There is a suggestion that relationship between SFC and HKEx and the demarcation of their specific powers and responsibilities be clarified.
18. There is also suggestion that Government, SFC and HKEx should establish a joint working group to draft a work flow chart setting out in detail the roles of SFC and HKEx in performing the listing functions, including their roles in relation to enforcement.
19. To enhance accountability of HKEx, there is a suggestion that an independent committee of the Board of HKEx be established to review performance of the listing function and ensure that this properly resourced. The independent committee would report its findings and recommendations to the full Board. In addition, SFC should carry out an annual review on the quantity and quality of resources allocated to the Listing Unit, the result of which would be reported to the independent committee mentioned above.

#### ***SEHK Listing Committee***

20. There is a suggestion that the budget of HKEx's Listing Unit and SEHK Listing Committee should be submitted to SFC for comments to improve the latter's oversight of the performance of listing functions by HKEx.
21. To minimize the perception that members of the SEHK Listing Committee have vested interests, some submissions suggest that the appointment and duties of members be reviewed and the composition of the Committee be broadened to increase investors' representation.
22. There are views that there should be some form of documentation which clearly defines the roles, powers and responsibilities of the SEHK Listing Committee, its chairman and members, and their relationship with staff of the Listing Unit.

23. There is a suggestion that the SEHK Listing Committee be restructured to clarify its accountability and enhance operational efficiency. The role of the SEHK Listing Committee should be defined as being to make decisions on individual listing applications and cancellation of listing status. There would be a separate Listing Policy and Appeals Committee which would make decisions on listing policy matters and hear appeals against decisions of the Listing Committee and the Listing Unit (other than disciplinary matters). There would also be a separate Disciplinary Appeals Committee to hear appeals against decisions of the HKEx Executive in disciplinary cases.

## List of Submissions

1. Anglo Chinese Corporate Finance Limited
2. CLP Holdings
3. Consumer Council
4. E2-Capital (Holdings) Limited
5. Hong Kong Exchanges and Clearing Limited
6. Hong Kong Federation of Women Lawyers
7. Hong Kong Society of Accountants
8. Hong Kong Stockbrokers Association
9. HSBC
10. HSBC Broking Securities (Asia) Limited
11. Law Society of Hong Kong
12. Linklaters on behalf of ten financial institutions<sup>28</sup>
13. Melco International Development Limited
14. Members of Hong Kong Investment Funds Association<sup>29</sup>
15. Mr. Alex Pang

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<sup>28</sup> The financial institutions are –

- (a) ABN AMRO Asia Limited
- (b) Citigroup Global Markets Asia Limited
- (c) Credit Suisse First Boston (Hong Kong) Limited
- (d) Deutsche Securities Asia Limited
- (e) ING Bank N.V.
- (f) J.P. Morgan Securities (Asia Pacific) Limited
- (g) Merrill Lynch (Asia Pacific) Limited
- (h) Morgan Stanley Dean Witter Asia Limited
- (i) Nomura Securities (Hong Kong) Limited

One financial institution has requested not to disclose its name.

<sup>29</sup> The Association itself does not offer comments.



16. Mr. David M Webb<sup>30</sup>
17. Mr. JE Strickland
18. Mr. Low Chee Keong
19. Mr. So Wai Man, Raymond
20. Securities and Futures Commission
21. The Association of Chartered Certified Accountants
22. The British Chamber of Commerce in Hong Kong
23. The Chamber of Hong Kong Listed Companies
24. The Chartered Institute of Management Accountants
25. The Chinese General Chamber of Commerce
26. The DTC Association (The Hong Kong Association of Restricted Licence Banks and Deposit-taking Companies)
27. The HK Association of Online Brokers
28. The Hong Kong Association of Banks
29. The Hong Kong Institute of Company Secretaries
30. The Hong Kong Institute of Directors
31. The Hong Kong Society of Financial Analysts Limited
32. The Institute of Securities Dealers
33. Value Convergence Holdings Limited
34. VC CEF Brokerage Limited
35. VC CEF Capital Limited

Plus 13 individuals/corporations who have requested their names not to be disclosed.

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<sup>30</sup> Further to the written submission of Mr Webb, we have received 52 e-mails indicating support for his submission, five of which have requested to remain anonymous. The remaining are, as far as we can trace, Agnes To, Andrew Cheng, Andy Chan, Au Ka Kau, Breen Paul Alexander, C C Tam, Chris Kwan, Christian Murck, Connie Tong, David Gunson, David Plumb, Fredy Y F Wan, G W H Cautherley, Grant Keats, Jackson Lam, Jason Wong, Jane Wong, Jimmy, John Hetherington, Karen Wong, Keith Ling, Kenneth Hung, Kevin S H Wong, Kho, Larry Baum, Lee Chung, Lok Hau Cheong, Luk Kwok Hung, Mark Hunter, Martin Chipp, Martin Lahm, Ng Shung Lung, Nicholas Sibley, Patrick Ma, Paul Tsang, Paul Zimmerman, Peter Lai, Robert Herries, Rupert Weng, Sara Shih, Simon Lai, Victor Tse, Vincent, Walton Cheung, William Young, Wong Wai Kwok and Yu Lee Ming Michael. We have also received one e-mail indicating that it does not support Mr Webb's submission and has requested to remain anonymous.

**Securities and Futures Ordinance (Cap. 571)**

**36. Rules by Commission**

- (1) Without prejudice to section 398(7) and (8), the Commission may make rules in respect of the following matters –
  - (a) the listing of securities, and in particular –
    - (i) prescribing the requirements to be met before securities may be listed;
    - (ii) prescribing the procedure for dealing with applications for the listing of securities;
    - (iii) providing for the cancellation of the listing of any specified securities if the Commission's requirements for listing, or the requirements of the undertaking referred to in paragraph (e), are not complied with or the Commission considers that such action is necessary to maintain an orderly market in Hong Kong;
  - (b) the conditions subject to which, and the circumstances in which, a recognized exchange company shall suspend dealings in securities or shall direct that dealings in securities recommence;
  - (c) the procedure for and the method of allotment of any securities arising out of an offer made to members of the public in respect of those securities;
  - (d) persons who may be admitted as an exchange participant of a recognized exchange company;
  - (e) requiring companies the securities of which are listed or accepted for listing to enter into an undertaking in the form prescribed in the rules with a recognized exchange company which may operate a stock market under section 19 to provide such information at such times as may be specified, and to

carry out such duties in relation to its securities as may be imposed, in the undertaking;

- (f) requiring a recognized exchange company which has become aware of any matter which adversely affects, or is likely to adversely affect, the ability of any exchange participant of the company to meet its obligations as an exchange participant, to make a report concerning the matter to the Commission as soon as reasonably practicable after becoming aware of the matter;
  - (g) requiring a recognized exchange company when it expels any of its exchange participants, or suspends any of its exchange participants from trading on the recognized stock market or recognized futures market it operates or through its facilities, or requests any of its exchange participants to resign as an exchange participant, to notify the Commission of that fact within 3 business days after the expulsion, suspension or making of the request (as the case may be) and, in addition, to cause the expulsion, suspension or request to be notified to the public in such manner and within such period as may be prescribed in the rules;
  - (h) any matter which is to be or may be prescribed by rules made under section 23.
- (2) Before making any rules in respect of any matter specified in subsection (1), the Commission shall consult –
- (a) the Financial Secretary; and
  - (b) the recognized exchange company or all the recognized exchange companies (as the case may be) to which that matter relates.
- (3) Nothing in this section prevents a recognized exchange company from making rules under section 23 on any matter referred to in subsection (1), but any such rules shall have effect only to the extent that they are not repugnant to any rule made by the Commission under subsection (1).

**Securities and Futures Ordinance (Cap. 571)**

**398. General provisions for rules by Commission**

- (1) Notwithstanding any other provisions of this Ordinance but subject to subsection (3), where the Commission proposes to make rules under any provision of this Ordinance, it shall publish a draft of the proposed rules, in such manner as it considers appropriate, for the purpose of inviting representations on the proposed rules by the public.
- (2) Where the Commission makes any rules under any provision of this Ordinance after a draft is published under subsection (1) in relation to the rules, it shall –
  - (a) publish, in such manner as it considers appropriate, an account setting out in general terms –
    - (i) the representations made on the draft; and
    - (ii) the response of the Commission to the representations; and
  - (b) where the rules are made with modifications which in the opinion of the Commission result in the rules being significantly different from the draft, publish, in such manner as it considers appropriate, details of the difference.
- (3) Subsections (1) and (2) do not apply if the Commission considers, in the circumstances of the case, that –
  - (a) it is inappropriate or unnecessary that such subsections should apply; or
  - (b) any delay involved in complying with such subsections would not be –
    - (i) in the interest of the investing public; or
    - (ii) in the public interest.

**Checks and balances governing the exercise of powers  
by Securities and Futures Commission (SFC)**

1. The Chief Executive (CE) appoints all the SFC directors; the majority of the members of the Commission shall be non-executive directors.
2. CE may give SFC directions regarding the performance of its duties and functions.
3. CE approves estimates of SFC's income and expenditure and the Financial Secretary (FS) causes the approved estimates to be laid before the Legislative Council (LegCo). The estimates are submitted to the Panel on Financial Affairs of LegCo for information.
4. SFC must prepare annual report and send a copy to FS who shall cause a copy to be laid before the LegCo.
5. SFC must furnish such information to FS as he may specify.
6. An independent Securities and Futures Appeals Tribunal, which has judicial status, hears appeals against certain decisions made by SFC.
7. Any SFC's decisions concerning the recognition and closure of exchanges (and clearing houses) and the issuance of restriction notice and suspension order in respect of exchanges (and clearing houses) may be appealed to CE in Council.
8. SFC must consult the public on draft subsidiary legislation to be made by it.
9. An independent Process Review Panel established by CE reviews SFC's internal operating procedures, including those for ensuring consistency and fairness.
10. Complaints against the actions of SFC or any of its staff may be lodged with the Office of the Ombudsman.
11. Judicial review by the Court of First Instance of relevant SFC decisions is available.

12. Director of Audit may examine records of SFC.
13. Under the Prevention of Bribery Ordinance, SFC is a public body. Its practices and procedures are subject to the examination of the Independent Commission Against Corruption (ICAC) under the ICAC Ordinance.