

Positioning Hong Kong as an International IPO Centre of Choice



June 2014

EXECUTIVE SUMMARY

Hong Kong has a long-standing reputation as one of the most popular destinations for capital-raising among major financial markets. It has benefited greatly from the strength of its legal system, availability of professional talent, and a generally business-friendly environment. Its political and geographical closeness to the China hinterland continues to put Hong Kong at a unique advantage as the gateway between China and the outside world. Over the years, the Government and regulators have tirelessly sought ways to expand and “internationalise” the market by attracting more overseas companies of good quality to list in Hong Kong.

Although Hong Kong can be justifiably proud of its successes so far, it is still some way from its stated goal of becoming a truly “international” initial public offering (“IPO”) centre – i.e. a market of choice for quality companies from all corners of the world seeking to raise public capital. In the past decade, important moves have been taken by the regulators towards diversification (e.g. updating and simplifying the rules for listing of overseas-incorporated companies and introducing the depositary receipt scheme). However, the pay-off from these efforts has been less than we might have cause to hope for. Today, the market remains heavily reliant on Mainland China for its pipeline of IPO candidates.

While the market regulators continue to work towards opening up the market and introducing more flexibility into our regulatory landscape, there have been few opportunities in the past to review, in a more holistic fashion, the fundamentals of this jurisdiction, especially basic infrastructural issues that may hamper further development.

In this paper we have set out some key areas which should be reviewed in detail and in which reforms may be called for. Of major importance are:

- certain distortive IPO practices which may dampen investor confidence;
- problems caused by the absence of a scripless (or dematerialised) securities holding system and proper market segmentation; and

- challenges we continue to face in cross-border enforcement and in enabling public investors to seek redress against corporate wrongdoing.

As we shall discuss below, some of these are infrastructural issues requiring longer term solutions based on in-depth planning and consultation, while others are more procedural in nature and may be addressed with relative expediency. We are not suggesting that Hong Kong will necessarily be attractive to every potential listing candidate in the world if the points raised in this paper are addressed. We believe, however, that there are a large number of potential listing candidates with no clear preference about their listing venue, whom our market may try to capture by generally modernising and rationalising its procedures.

The recently-launched Shanghai-Hong Kong Stock Connect pilot programme provides an important catalyst in further strengthening the importance of Hong Kong as a capital raising centre. We believe that many listing candidates from different corners of the world will be attracted to the prospect of being able to access the investor base in the Mainland by opting to list in Hong Kong. It is crucial for Hong Kong to capture the opportunities created by this pilot programme and propel itself forward in the course of internationalisation as an IPO centre.

We recommend that Hong Kong's policy-makers should conduct an overall review of the surrounding legal and financial landscape and identify ways in which Hong Kong may start to reap concrete rewards in its efforts towards internationalisation. Pending such review, we encourage the market regulators to be proactive and flexible in their administrative practices, so that the market will see, sooner rather than later, improvements in key aspects that do not require consultation or law- or rule-making processes, or where such processes may be expedited.

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Section 1 INTRODUCTION

1.1 HONG KONG IS A LEADING CAPITAL MARKET

Hong Kong has a long-standing reputation as one of the most popular destinations for capital-raising amongst major global financial markets. As at the end of March 2014, Hong Kong ranks sixth worldwide and second in Asia in terms of total market capitalisation of all listed companies.

	World- wide Ranking	Ranking in Asia	Total Market Capitalisation of All Listed Companies (US\$ billion)
US (NYSE Euronext)	1		18,306.14
US (Nasdaq OMX)	2		6,543.95
UK (London Stock Exchange Group)	3		4,651.54
Japan (Japan Exchange Group)	4	1	4,316.49
Europe (NYSE Euronext)	5		3,734.83
Hong Kong	6	2	2,973.38
China (Shanghai)	7	3	2,376.03
Canada (Toronto)	8		2,149.52
Germany (Deutsche Börse)	9		1,941.48
Switzerland	10		1,611.18
Australia	11	4	1,434.09
China (Shenzhen)	12	5	1,429.45
Northern Europe (NASDAQ OMX Nordic Exchange)	13		1,344.98
India (Bombay)	14	6	1,241.63
Korea	15	7	1,232.34

Figure 1-1: Market Capitalisation of the World's Top Stock Exchanges (end of March 2014) ¹

The Hong Kong market has benefited from the following advantages:

Regulatory Regime. Hong Kong's robust legal framework based on English common law, and adoption of International Financial Reporting Standards ("IFRS"), provide a strong and attractive foundation for fund-raising activities. Investors from all over the world have confidence in the clarity and enforceability of their legal rights, as well as the comparability and reliability of the financial information made available

¹ SFC Market & Industries Statistics Q1 2014 (quoting the World Federation of Exchanges).

to them, which are reinforced by the sophisticated banking, clearing and settlement infrastructure in Hong Kong.

Financial Policies. In terms of general business environment, Hong Kong offers various advantages, such as low tax rates, currency convertibility, unrestricted capital flows and freedom of information. These factors are instrumental in making Hong Kong one of the most open markets in the world.

1.2 HONG KONG IS CHINA'S INTERNATIONAL FINANCIAL CENTRE

Hong Kong's ongoing success is supported by its strategic location as a gateway for the world to China and the rest of Asia, which have displayed impressive economic growth in recent years. Hong Kong Exchanges and Clearing Limited ("**HKEx**") is often a prime choice for companies that are incorporated or have their principal places of business in the People's Republic of China ("**PRC companies**") seeking a listing on an international market.

1.3 HONG KONG IPO AS A GATEWAY FOR OVERSEAS COMPANIES

The Hong Kong market actively promotes itself as a gateway for foreign companies seeking to access capital funding in China and other Asian countries, which in the past have proved relatively attractive for industries such as luxury retail brands and natural resources. Listing on the HKEx boosts a company's branding in the Asia-Pacific region, which is one of the fastest-growing markets in the world for these commodities. The number of international enterprises listed in Hong Kong has increased substantially from 2006 to 2011: see Figure 1-2. The 19 international listings in 2011 almost doubled the 10 registered in 2007. High-profile corporations such as Prada (1913.HK), L'Occitane (973.HK) and Samsonite (1910.HK) have all chosen Hong Kong to be their market for listing and fund-raising.

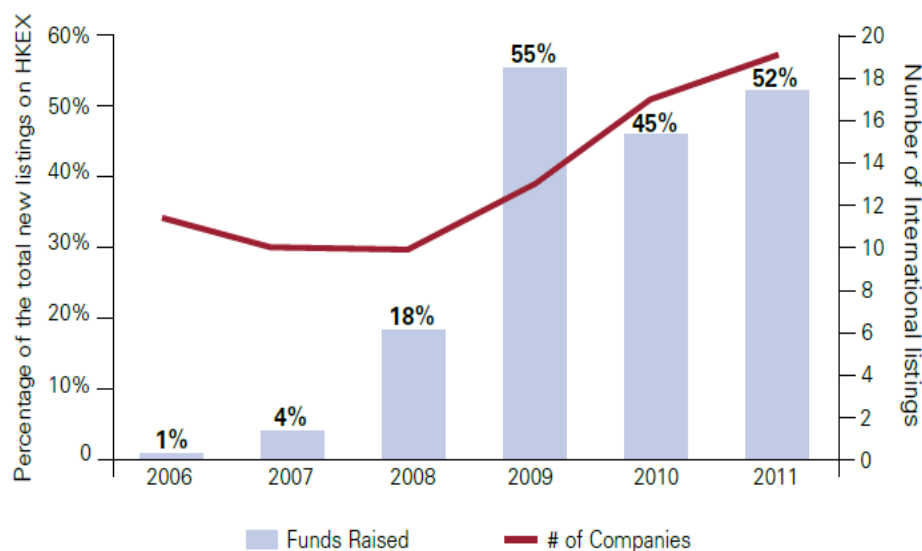


Figure 1-2: International listings on the HKEx²

However, although the HKEx remains one of the top global performers in terms of capital raised, at present PRC companies account for a substantial portion of the Hong Kong listed market. As at the end of April 2014, H share, red chip and Mainland private enterprises accounted for 55.8% of the market capitalisation and 70.2% of the equity turnover value of all Hong Kong listings (Main Board and Growth Enterprise Market (“GEM”) combined)³. The high level of reliance placed on PRC companies may undermine the HKEx’s status as an “international” market and its long term development.

In a recent news report⁴, the shortcoming was hammered home when Hong Kong was referred to as a “one-dimensional market”. The author of this study pointed out that financial and property firms dominate the benchmark Hang Seng Index, with a 54% weighting by free-float market value. The report noted that there were only two technology companies (both PRC Internet enterprises) in the index (which currently has 50 constituents), and PRC State-owned enterprises accounted for 38% of

² “Listing on the Hong Kong Stock Exchange”, HKEx, February 2012 (cited in “Hong Kong – Asia’s Global Market, a Destination for International Listings”, KPMG 2012).

³ HKEx Monthly Market Highlights, April 2014.

⁴ “Heard on the Street – Hong Kong’s Alibaba Lament”, Aaron Back, Wall Street Journal, 18 March 2014.

the weighting. A illustrative graph accompanying this report is reproduced as Figure 1-3:

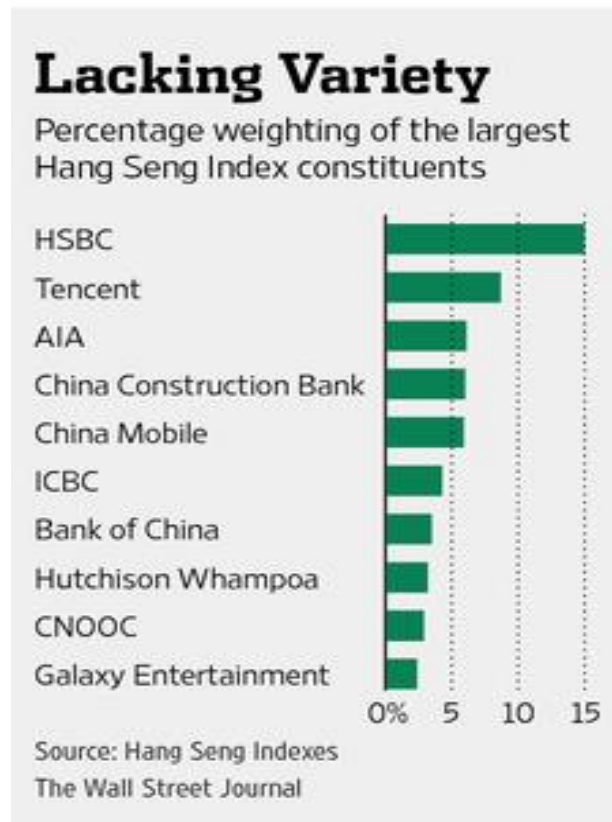


Figure 1-3: Percentage weighting of the largest Hang Seng Index constituents⁵

Both the Government and the HKEx are actively seeking ways to build on existing success and strengthen Hong Kong’s competitiveness as a truly international finance centre.

1.4 POSSIBLE WAY FORWARD

Admittedly, there may be overriding geopolitical, social and other reasons for companies to prefer certain capital markets of the world. Some companies will be unlikely to desire a Hong Kong listing even if all the points raised in this paper are addressed, while others will prioritise Hong Kong despite its perceived drawbacks. Between these two poles, there are a large number of good quality potential listing candidates that are “agnostic” but may have been deterred from coming to Hong

⁵ Ibid.

Kong by specific systemic concerns. By reviewing and modernising our market infrastructure, Hong Kong will be able to put itself in the best position to attract these candidates.

With the introduction of the Shanghai-Hong Kong Stock Connect pilot programme and the availability of mutual stock market access between Hong Kong and the Mainland, Hong Kong is poised to make substantial headway in further consolidating its position as China's gateway to the world. More importantly, this may be an additional incentive for overseas companies to list in Hong Kong and thereby gain access to both the Hong Kong and Mainland capital markets. The regulators should consider the ways in which our market can optimise this unique opportunity for growth.

One possible way forward is to make Hong Kong more attractive by reducing the regulatory burden for listed companies. This does not necessarily mean a simple lowering of standards. Instead, by suitably streamlining the regulatory processes and making structural changes to the market, the same safeguards for market integrity and shareholders' protection can be upheld even if the rules are made less stringent. If the right balance can be struck between market efficiency and high regulatory standards, introducing a suitable level of flexibility in the rules may help attract more types of enterprises to the market and diversify the range of companies listed in Hong Kong.

This paper provides a comparative analysis of the key underlying reasons which have contributed to the current imbalance. It also examines a number of reform options which we believe may help attract more overseas companies to be listed on the HKEx.

Section 2 OVERSEAS COMPANY LISTINGS IN HONG KONG – AN OVERVIEW

2.1 IS HONG KONG A TRULY INTERNATIONAL IPO CENTRE?

2.1.1 Overseas issuers

Hong Kong's ability to attract overseas issuers can be assessed using two indicators: growth in the number of overseas company listings and the diversification of jurisdictions in which the companies are incorporated or headquartered.

Growth in the number of overseas listing applicants has been encouraging since 2007. According to the findings of a report produced by one of the major international accounting firms,⁶ in 2007, overseas companies raised only 4% of the total funds raised in Hong Kong, but by 2011, their share had shot up to 52%: see Figure 2-1. However, it is doubtful if the strong trend can be maintained. Fundraising dropped significantly in 2012 which saw the listing of only two overseas companies in Hong Kong, accounting for about 15% of the total proceeds raised during the first half of 2012.⁷ The position has not improved significantly in 2013, which saw some 87 Main Board listings⁸ only one of which, with the listing applicant being incorporated in the British Virgin Islands,⁹ technically qualifies as an "international listing" although the company is owned and managed by Mainland residents and operates a PRC-based oilfield business.¹⁰

⁶ "Hong Kong – Asia's Global Market, A Destination for International Listings", KPMG, September 2012, p 12-13.

⁷ "Hong Kong – Asia's Global Market, A Destination for International Listings", KPMG, September 2012, p 5.

⁸ Including eight transfers from the Growth Enterprise Market and five listings by introduction.

⁹ See the discussion on "Recognised Jurisdictions" and "Acceptable Jurisdictions" in Section 3 below.

¹⁰ Termbray Petro-King Oilfield Services Limited; two prospective "overseas company" listings in 2013, Mando China Holdings (incorporated in Korea) and M&G Chemicals (incorporated in the Grand Duchy of Luxembourg) did not proceed.

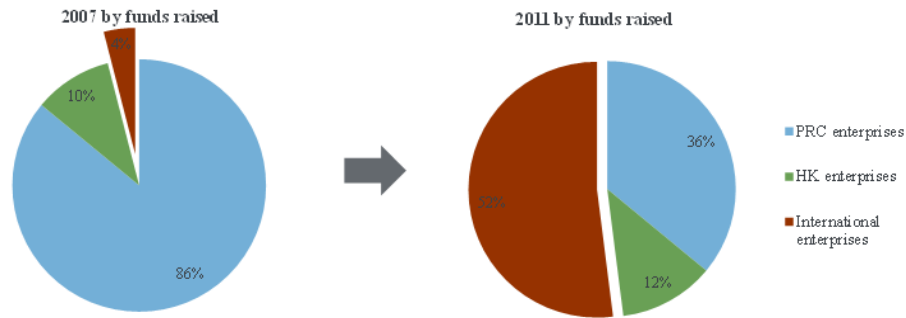


Figure 2-1: Distribution of funds raised on the HKEx in 2007 and 2011¹¹

There has also been an obvious trend of country diversification from 2007 to 2011. From 2006 to 2008, PRC companies accounted for all of the top ten Hong Kong IPOs (in terms of capital raised). From 2009 to 2011, overseas companies accounted for half the number of the top ten list: see Figures 2-2 and 2-3.

Company	Funds raised (US\$ billion)	Headquarter Country
Industrial and Commercial Bank of China Ltd	16.0	PRC
Bank of China Ltd	11.1	PRC
China CITIC Bank Corporation Ltd	4.2	PRC
China Railway Group Ltd	2.8	PRC
China Merchants Bank Co., Ltd	2.7	PRC
China Railway Construction Corporation Ltd	2.6	PRC
China Communications Construction Co., Ltd	2.4	PRC
China Coal Energy Co., Ltd.....	1.9	PRC
Country Garden Holdings Co., Ltd	1.9	PRC
SOHO China Ltd	1.9	PRC

Figure 2-2: 2006-2008 Top 10 IPOs in terms of funds raised on the HKEx¹²

Company	Funds raised (US\$ billion)	Headquarter Country*
AIA Group Ltd	20.4	US
Agricultural Bank of China Ltd	12.0	PRC
Glencore International Plc	10.0	Switzerland
China Minsheng Banking Corp., Ltd.....	4.0	PRC
China Pacific Insurance (Group) Co., Ltd.....	3.6	PRC
China Longyuan Power Group Corporation Ltd	2.6	PRC
Sands China Ltd	2.5	US
PRADA S.p.A.....	2.5	Italy
Metallurgical Corporation of China Ltd	2.3	PRC
United Company RUSAL Plc	2.2	Russia

*According to the classification adopted by the authors of the source document

Figure 2-3: 2009-2011 Top 10 IPOs in terms of funds raised on the HKEx¹³

¹¹ "Listing on the Hong Kong Stock Exchange", HKEx, February 2012.

¹² "Hong Kong – Asia's Global Market, A Destination for International Listings", KPMG, September 2012, p 13.

¹³ Ibid.

Despite the encouraging trend in the past decade, there remains plenty of room for further diversification. PRC-incorporated and PRC-based companies still accounted for 55.8% of the market capitalisation as at the end of April 2014: see Figure 2-4. Further, the majority of companies applying to list on the HKEx are from the traditional jurisdictions of Hong Kong, Bermuda, Cayman Islands and the PRC (together the “Recognised Jurisdictions”).¹⁴

Of the 87 companies listed on the Main Board in 2013, 68 were incorporated in the Cayman Islands, two in Hong Kong, 11 in the PRC, five in Bermuda and one in the British Virgin Islands.¹⁵ As at the end of 2013, only 1% of all Main Board-listed issuers were incorporated in countries outside the Recognised Jurisdictions: see Figure 2-5.

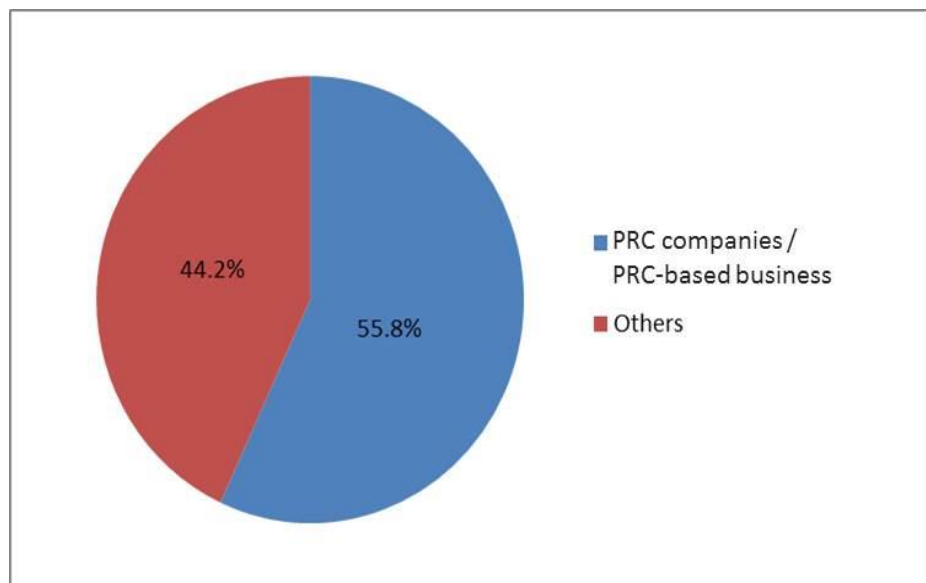


Figure 2-4: Listed companies in Hong Kong (market capitalisation)¹⁶

¹⁴ See section 3.1.1 for more on Recognised Jurisdictions.

¹⁵ New Listing Report 2013, HKEx.

¹⁶ HKEx Monthly Market Statistics, April 2014.

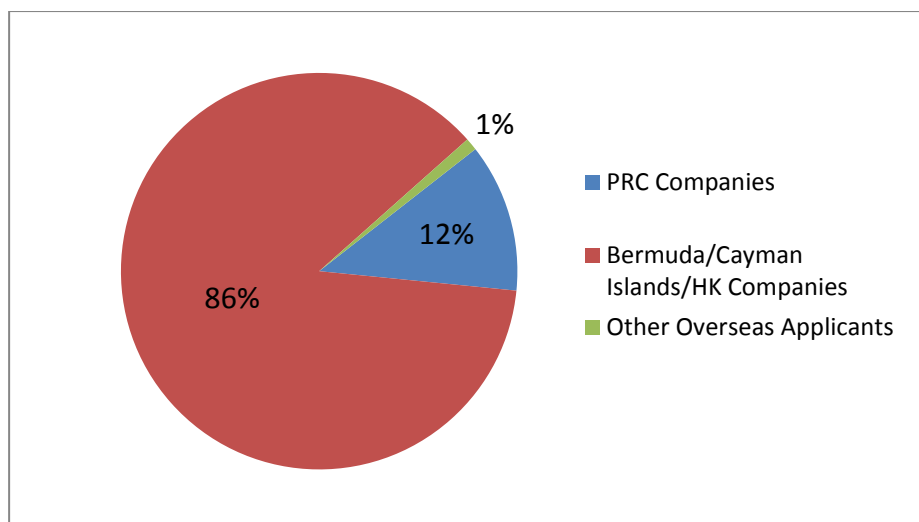


Figure 2-5: Main Board listed companies classified by place of incorporation¹⁷

2.1.2 Secondary listing

Despite the HKEx's efforts in promoting itself as a venue for secondary listings, there are currently only 10 secondary-listed companies¹⁸ on the HKEx. Of these, six were listed in Hong Kong by way of introduction with no capital raising in Hong Kong and four were listed by global offering. Generally speaking, trading in these stocks has not been very active after listing.

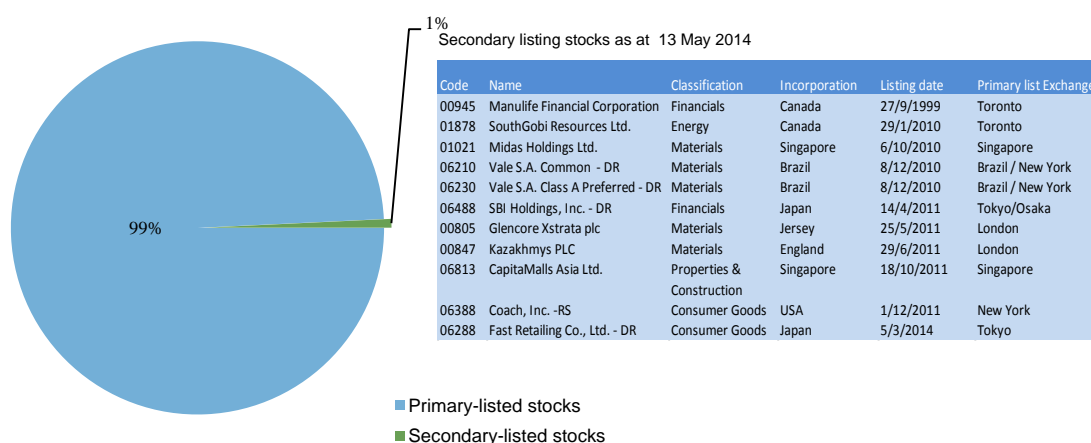


Figure 2-6: Secondary-listed stocks on the HKEx¹⁹

¹⁷ HKEx New Listing Report 2013.

¹⁸ See section 3.2 for more on secondary listing in Hong Kong.

¹⁹ HKEx List of Equities as at 13 May 2014.

2.1.3 Listed Hong Kong Depositary Receipts

The Hong Kong depositary receipt regime was launched in 2008 (see section 3.3.1). Its reception in the following five years has been somewhat lacklustre. As at 13 May 2014 there were only five listed Hong Kong Depositary Receipts for four listed issuers²⁰ (compared to 1,453 listed equity securities²¹) on the Main Board.²²

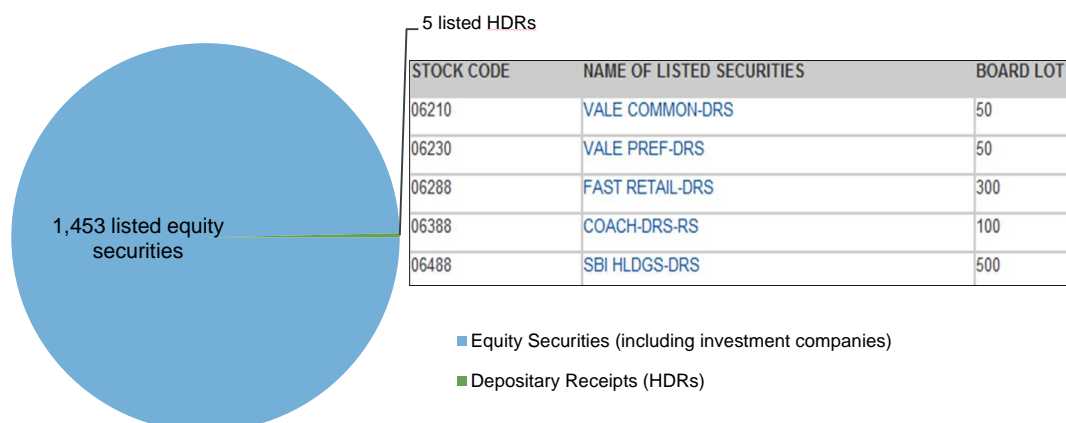


Figure 2-7: Listed HDRs as at end of 20 March 2014²³

2.1.4 Market comparison

Singapore Exchange

The HKEx and the Singapore Exchange (“**SGX**”) are the regional hubs for cross-border listings in the Asia-Pacific region. In terms of total market capitalisation of listed issuers, the HKEx was approximately four times the size of SGX by the end of April 2014: see Figure 2-8. However, some commentators claim that Singapore is “Asia’s most internationalised exchange”. A joint publication by an international accounting firm and an international law firm in 2012 reported that out of the 239 cross-border IPOs in the Asia-Pacific region from 2002 to

²⁰ See section 3.3 for more on Hong Kong Depositary Receipts.

²¹ HKEx List of Securities as at 13 May 2014.

²² In March 2014, SBI Holdings Inc., the first Japan-listed company to be secondary-listed in Hong Kong, announced its plans to delist its HDRs from the HKEx as from 25 June 2014. The company cites, among other reasons, the minimal trading volume in Hong Kong and the sharp decline (from 9.1% at the time of the HDR listing to 0.05% at the time of announcement of the delisting) in the ratio of number of HDRs to the total number of issued shares.

²³ Ibid.

2011, 130 companies listed on SGX.²⁴ Further, according to SGX’s own data as of December 2012, international companies accounted for 39% of the SGX’s total market capitalisation; the number was a low 6% for the HKEx: see Figure 2-9.²⁵

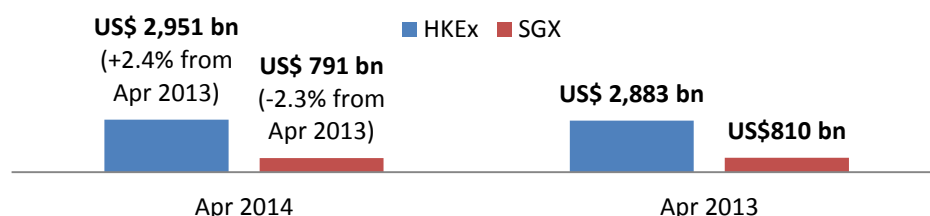


Figure 2-8: A comparison of market capitalisation of listed issuers between the HKEx and SGX²⁶

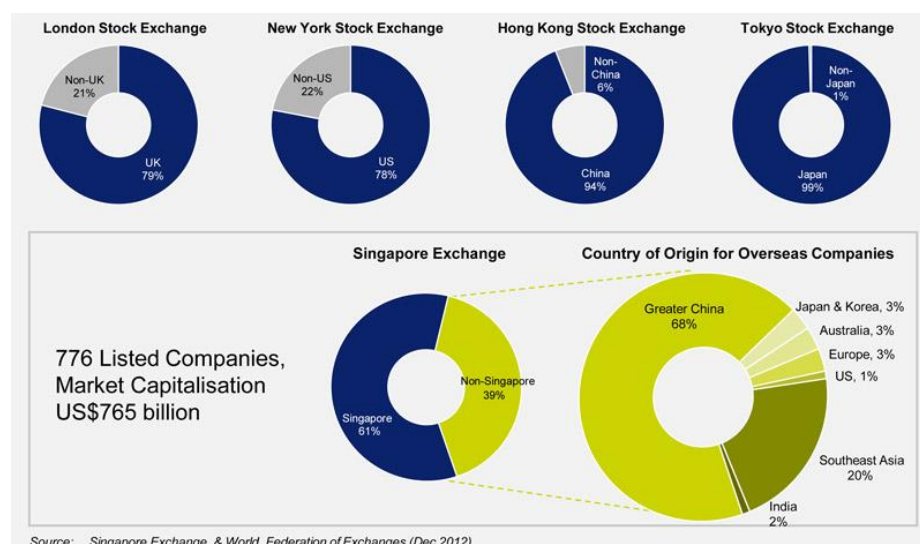


Figure 2-9: International listings as a percentage of all listed companies in various exchanges

Other global exchanges

Overseas listing on the HKEx is still relatively immature compared to the other major exchanges. From 2002 to 2011, the London Stock Exchange (“LSE”) was the leading destination for cross-border IPO activity. The

²⁴ “Equity sans frontières”, PricewaterhouseCoopers and Baker & McKenzie, November 2012. Note that for this study, listings of PRC companies in Hong Kong are considered domestic, not cross-border listings.

²⁵ Note that PRC companies were regarded as domestic companies in the survey.

²⁶ World Federation of Exchanges, 2014.

480 cross-border IPOs from 2002 to 2011 on the LSE constituted 41% of cross-border IPOs worldwide during that period. In contrast, only 2% of cross-border IPOs worldwide in the same period took place in Hong Kong. The sophisticated development of overseas listing on the LSE is further highlighted by the fact that the average size of an inbound IPO was 2.7 times that of an average domestic IPO. Lastly, the LSE has a well-diversified base of key foreign issuers, encompassing companies from Russia (45 issuers, facilitated by the availability of the global depositary receipt (“GDR”) structure), the United States (62 issuers) and India (32 issuers).

The second-placed New York Stock Exchange’s (“NYSE”) 264 cross-border IPOs accounted for 23% of all cross-border IPOs in the 2002-2011 period. Nevertheless, there is less diversification in NYSE, as 134 issuers (51% of the cross-border IPOs on NYSE) were PRC companies, many through backdoor listing – a mode of entry which subsequently came under close regulatory scrutiny in the US and may no longer be available to future issuers.

Figure 2-10 is an overview of cross-border IPOs²⁷ during the decade between 2002 and 2011.

<u>At 31 December 2011</u>	<u>London</u>	<u>New York</u>	<u>Hong Kong</u>	<u>Singapore</u>
Total number of issuers.....	2,886	4,988	1,496	773
Total market cap (US\$bn)....	3,266	15,641	2,258	598
Total number of foreign issuers.....	598	817	24	311
No. of IPOs (2002 – 2011) ...	1,414	1,617	682	451
Proceeds (US\$bn) raised by IPOs (2002 – 2011)	191	381	231	33
No. of cross-border IPOs (2002 – 2011)	480	264	19	183

²⁷ In the source material, a cross-border IPO is defined as an IPO where 50% or more of the proceeds are raised on a non-domestic exchange. Secondary dual listings are not considered. Listings from Mainland China into Hong Kong are considered as domestic transactions. For dual IPOs where information about the division of the proceeds is not available, IPOs taking place in the neighbouring exchanges are classified as domestic. All dual IPOs are allocated to the primary exchange (e.g. where 50% or more of the proceeds were raised) – “Equity Sans Frontières”, PricewaterhouseCoopers and Baker & McKenzie, November 2012.

<u>At 31 December 2011</u>	<u>London</u>	<u>New York</u>	<u>Hong Kong</u>	<u>Singapore</u>
Proceeds (US\$bn) raised by cross-border IPOs (2002 – 2011)	110	56	9	15
% of cross-border IPOs (volume)	34%	16%	3%	41%
% of cross-border IPOs (proceeds)	58%	15%	4%	45%

Figure 2-10: Cross-border activity on four global exchanges²⁸

²⁸ “Equity Sans Frontières”, PricewaterhouseCoopers and Baker & McKenzie, November 2012; PwC data based on World Federation of Exchanges and Dealogic data.

Section 3 THE CURRENT REGULATORY REGIME

3.1 FACILITATING ENTRY BY OVERSEAS COMPANIES

3.1.1 Evolution of the HKEx's approach

Traditionally, companies listed on the HKEx must be incorporated in Hong Kong, Bermuda, Cayman Islands or the PRC. They are referred to as the "Recognised Jurisdictions".

In recent years, more jurisdictions have been accepted by the HKEx for listing in order to open up the market to more issuers. These are referred to as the "Acceptable Jurisdictions". As at the date of this document, the Listing Committee of the HKEx has approved, in principle, 21 countries and regions as Acceptable Jurisdictions of incorporation.

3.1.2 The Joint Policy Statements

The Hong Kong regulators effected this opening up of the Hong Kong market to more Acceptable Jurisdictions mainly by way of a Joint Policy Statement Regarding the Listing of Overseas Companies, issued jointly by the HKEx and the Securities and Futures Commission ("**SFC**") on 7 March 2007 ("**2007 JPS**"). Six and a half years later in September 2013, a new edition of the JPS ("**2013 JPS**") was released.

The spirit underpinning both the 2007 JPS and 2013 JPS is that, while more overseas issuers should be admitted for listing in Hong Kong, the jurisdictions of incorporation of such issuers should have safeguards for shareholders at least equivalent to those of Hong Kong, such as rights to appoint and remove directors, voting at general meetings and rights upon winding-up of the company.

3.1.3 Increasing flexibility under the 2007 JPS

Under the 2007 JPS, the approval of a new jurisdiction by the HKEx was assessed on a case-by-case basis. In practice, the process of comparing between the laws of different jurisdictions was often highly complex and time-consuming. Even where it was possible to compare between different legal systems, issuers might have to demonstrate the requisite

shareholders' protection safeguards by a line-by-line comparison of the laws.

In some cases, comparing different legal systems could be a contrived project, as systems (e.g. the common law and civil law systems) may be built on such vastly different conceptual foundations as to afford very little basis for meaningful comparison.

Nevertheless, the 2007 JPS and subsequent HKEx guidance significantly clarified the regulatory approach and eased the way for overseas company listings. Significant headway was gained by adopting two key concepts:

- “piggybacking”: Once a company from a new jurisdiction has been accepted, companies from the same jurisdiction do not have to repeat the comparison process for the same matters. They can simply follow the forerunner on those matters.
- “cross-benchmarking”: Once a jurisdiction has been accepted, it becomes in itself a benchmark for comparison for other jurisdictions. For example, an Austrian company and a German company are technically both required to compare their own laws with those of Hong Kong. But as Germany is already an “Acceptable Jurisdiction” in Hong Kong, any Austrian company that seeks a listing in Hong Kong has the choice of benchmarking itself either to Hong Kong or to German standards, which may mean significant savings in time and costs.

3.1.4 Further streamlining under the 2013 JPS

In the 2013 JPS, the SFC and the HKEx sought to streamline further the regulation of overseas companies listings. The two-tiered structure of “Recognised Jurisdictions” and “Acceptable Jurisdictions” are retained and the requirements applying to the latter category of companies have been clarified. These are as follows:

- (A) An applicant from an existing or prospective “Acceptable Jurisdiction” must explain how its domestic laws and regulations in combination meet the shareholder protection standards required by the HKEx. A number of Country Guides have been produced for countries that have been accepted by the HKEx for

this purpose as guidance to the applicant. The HKEx's main concerns in this respect are, in summary:

- matters requiring super majority vote;
 - individual members' approval required for increasing members' liability;
 - appointment, removal and remuneration of auditors; and
 - proceedings at general meetings.
- (B) For an applicant whose place of incorporation, central management and control is outside Hong Kong, the HKEx requires the statutory securities regulator in the domestic jurisdiction to be a full signatory of a specified document for international cooperation among securities regulators,²⁹ or to have entered into a relevant bilateral agreement with the SFC for mutual assistance, unless the HKEx agrees to make an exception (on an individual case basis and subject to the consent of SFC).
- (C) An applicant proposing to use auditing standards other than the ones previously accepted by the HKEx³⁰ must apply for the proposed standards to be recognised. As for accounting standards, generally the HKEx accepts four standards for accountants' reports and financial statements for listing applicants.³¹ Where a proposed financial reporting standard does

²⁹ The International Organisation of Securities Commission's Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information ("IOSCO MMOU").

³⁰ In paragraph 50 of the 2013 JPS, the HKEx sets these out as follows:

- (i) the Australian Auditing Standards;
- (ii) the Canadian Generally Accepted Auditing Standards;
- (iii) professional auditing standards applicable in France;
- (iv) the Italian Auditing Standards;
- (v) the Singapore Standards on Auditing;
- (vi) the Standards for Investment Reporting issued by the Auditing Practice Board in the UK; and
- (vii) the US Public Company Accounting Oversight Board auditing standards.

³¹ Under Listing Rule 4.11, these are:

- (i) Hong Kong Financial Reporting Standards ("HKFRS") issued by the Hong Kong Institute of Certified Public Accountants;
- (ii) International Financial Reporting Standards ("IFRS"); and
- (iii) China Accounting Standards for Business Enterprises ("CASBE") in the case of a qualifying PRC company.

Additionally, the HKEx has accepted US Generally Accepted Accounting Principles ("GAAP"), in a case where the company was dual-listed in Hong Kong and on an overseas exchange.

not differ significantly from IFRS or where there are concrete proposals for the two standards to converge, the HKEx may be willing to accept such proposed standard. In the past, the HKEx has accepted a number of additional standards on this basis.³² In addition, both the Listing Rules and Hong Kong legislation³³ require reporting accountants in a listing application to be professionally qualified in Hong Kong and a waiver and exemption from these requirements must continue to be sought specifically if alternative accountants' qualifications are proposed.³⁴

- (D) For listing applicants that are prevented by domestic laws or regulations from complying with the Hong Kong requirements³⁵, the HKEx states that a variety of methods may be used to fill the gap, such as undertakings given to the Hong Kong regulators and internal compliance measures adopted by the applicant. Importantly, the "nexus" test has been removed so that a listing applicant is no longer required to demonstrate a nexus between its place of incorporation and place of principal business operations.

3.1.5 Observations on the 2013 JPS

General approach largely unchanged

³² These are set out in paragraph 59 of the 2013 JPS:

- (i) EU-IFRS for EU companies;
- (ii) US GAAP for companies with or seeking a dual primary listing in the US and Hong Kong;
- (iii) for companies with or seeking a dual-primary or secondary listing in Hong Kong:
 - Australian GAAP;
 - Canadian GAAP;
 - Japanese GAAP;
 - Singapore Financial Reporting Standards; and
 - UK GAAP.

³³ Paragraph 43 of the Third Schedule to the Companies (Winding Up and Miscellaneous Provisions) Ordinance.

³⁴ Paragraph 53 of the 2013 JPS requires reporting accountants and auditors to be independent of the listing applicant and Paragraph 54 states that alternative qualifications would generally be considered acceptable if the firm:

- (i) has an international name and reputation;
- (ii) is a member of a recognised body of accountants; and
- (iii) is subject to independent oversight by a regulatory body of a jurisdiction that is a signatory to the IOSCO MMOU.

³⁵ Including the Listing Rules and the Code on Takeovers and Mergers and Share Buy-backs.

The Hong Kong regulators have made some headway in the 2013 JPS in terms of clarification and standardisation of the requirements for an overseas company listing. A number of detailed operational matters have been clarified (e.g. prospectus disclosure requirements, compatibility of the securities with Hong Kong's settlement and clearing system, requirement for the applicant to have a register of members in Hong Kong, availability of shares on the Hong Kong share register for trading, disclosure and reporting requirements in respect of tax matters, etc.). However, the main policy approach is largely kept intact, particularly the crucial questions of how a new country is in practice added to the list of "Acceptable Jurisdictions" and how in practice a listing applicant from a country not on that list is expected to demonstrate shareholders' protection standards equivalent to the Hong Kong standards.

In the 2013 JPS the regulators have removed the concept of "cross-benchmarking". New listing applicants from a country already on the Acceptable Jurisdiction list and those from countries not currently on that list will be guided by the Country Guides which the HKEx published towards the end of 2013.

No broadening of accounting standards acceptance

With the overall 2007 regulatory structure largely kept intact, no major reforms have been made in the 2013 JPS in terms of opening up the market to more accounting standards. This is often crucial in practice. For an overseas company whose accounts may have been for many years prepared on accounting standards not on the HKEx's list of acceptable standards, a first hurdle for applying for a Hong Kong listing is either to prepare new financial information (with substantial time and cost implications to the applicant), or to apply to the HKEx for specific waivers – in practice, such waivers are generally not granted.

The acceptance of more overseas accounting standards is a cogent topic in the "internationalisation" of a global IPO market. For example, it has been reported that potential American Depositary Receipts issuers seeking entry to the US market have to restate their financial statements in accordance with US GAAP, which differ in material respects from international standards. As a result, issuers preferred the GDR regime on LSE which allowed them to achieve their objectives

without incurring the expense of reconciling their accounts to US GAAP (which they would have been required to do if they issued ADRs in the US). This, in turn, drove the US Securities and Exchange Commission to accept accounts conforming to IFRS in 2009.³⁶

It remains to be seen whether the 2013 JPS, despite its limited scope of reform, will help to open up the Hong Kong market to overseas companies of good quality.

3.2 SECONDARY LISTING

3.2.1 Background

If an issuer already has a primary listing on another exchange, it can apply for a secondary listing in Hong Kong. Hong Kong secondary-listed companies are usually companies with large capitalisations, a history of regulatory compliance and a primary listing on a reputable stock exchange.

Historically, secondary listings have not been vibrant in Hong Kong and the relevant listing rules were not well-developed. Prior to 2010, there had been only one secondary-listed company in Hong Kong for many years³⁷. Some reputable companies have obtained and subsequently withdrawn their secondary listings years ago³⁸.

One of the objectives of the 2007 JPS was to encourage secondary listings in Hong Kong. This was largely successful. Nine of the 10 current secondary-listed companies were listed after the publication of the 2007 JPS: See Figure 2-6.

3.2.2 Listing requirements

In principle, the same listing requirements apply to a listing applicant regardless of whether it seeks a primary or a secondary listing in Hong Kong. In practice, however, the HKEx have on a case-by-case basis

³⁶ "The Global Appeal of DRs", FTSE Global Markets March/April Issue 2008.

³⁷ The 1999 secondary listing of Manulife Financial Corporation, incorporated in Canada, with a primary listing in Toronto Stock Exchange.

³⁸ For example, Peninsular and Oriental System Navigation Company (i.e. P&O) with deferred shares listed in 1991 and de-listed in 2000.

granted extensive waivers to an entity seeking a secondary listing, provided that public shareholders' rights are not materially prejudiced.

The SFC and the HKEx have revisited secondary listings in the 2013 JPS. The key innovation is a standardised list of automatic waivers from the Listing Rules for an applicant for a Main Board secondary listing, provided it is a company that:

- has a market capitalisation in excess of US\$400 million and has been listed for at least five years on the primary market (which track record may be waived if the applicant is well-established and has a market capitalisation significantly larger than US\$400 million), normally with a long track record of clean legal and regulatory compliance on the primary market;
- has a primary listing on one of the 15 exchanges set out in the 2013 JPS³⁹ (provided that the applicant has not been waived or exempted from compliance with the laws or rules of the primary market); and
- has a “centre of gravity” outside China.⁴⁰

The regulators are to be commended for standardising and improving transparency in the waiver process. While the previous policies were largely unwritten and occasionally convoluted, the 2013 JPS has moved things forward by setting out the waivers from individual listing requirements that will be granted on an “automatic” or “commonly granted” basis. For example, the restriction on disposal of shares by controlling shareholder for six months following listing⁴¹ will be automatically waived for a Main Board secondary listing applicant

³⁹ The 15 exchanges are: the Amsterdam Stock Exchange (NYSE Euronext – Amsterdam); the Australian Securities Exchange (ASX); the Brazilian Securities, Commodities and Futures Exchange; the Frankfurt Stock Exchange (Deutsche Börse); the Italian Stock Exchange (Borsa Italiana); the London Stock Exchange (LSE); the Madrid Stock Exchange (Bolsa de Madrid); NASDAQ OMX (US); the New York Stock Exchange (NYSE Euronext (US)); the Paris Stock Exchange (NYSE Euronext - Paris); the Singapore Stock Exchange (SGX); the Stockholm Stock Exchange (NASDAQ OMX – Stockholm); the Swiss Exchange (SIX Swiss Exchange); the Tokyo Stock Exchange (TSE) and the Toronto Stock Exchange (TMX).

⁴⁰ This concept is not defined, although the HKEx has indicated a number of factors that will be taken into account when determining the issue – e.g. the location of the applicant's headquarters, its central management and control, its main business operations and assets, its corporate and tax registration, the nationality and country of residence of its management and controlling shareholders.

⁴¹ Listing Rule 10.07(1).

meeting the criteria above. For an applicant applying for dual primary listings in Hong Kong and another market, a waiver from this same rule will be in the “common waiver” category. This standardisation reduces much of the uncertainty in the secondary listing process and is a welcome development.

A secondary listing candidate incorporated outside the Recognised Jurisdictions must in addition comply with the requirements summarised in (A) and (B) of section 3.1.4 above.

It remains to be seen whether the 2013 JPS will bring about a growth in secondary listings.

3.3 LISTING BY WAY OF HONG KONG DEPOSITARY RECEIPTS

3.3.1 Background

Under its Strategic Plan 2007-09 which affirmed the goal of listing more overseas companies, the HKEx introduced Hong Kong Depositary Receipts (“**HDR**”) on 1 July 2008.

Prior to the HDR regime, companies seeking a listing in Hong Kong were required by the Listing Rules to maintain a share register in Hong Kong. Technical difficulties can arise for companies from jurisdictions which restrict movements of shares abroad or prohibit an overseas register or splitting of the register. Hong Kong investors may also be deterred from owning foreign stocks directly due to the inconvenience of having to receive dividends in another currency.

After detailed consideration, the HKEx has introduced the HDR regime as a solution to these problems. The depositary, usually a financial institution, takes delivery of shares and issues another instrument, namely depositary receipts (“**DRs**”) in a given ratio in respect of these shares in the market of listing. The depositary holds the shares for the benefit of the DR holders, collects and converts dividends, and handles voting and entitlements on the DR holder’s behalf. Apart from directly listing the shares of a company, such shares may now be bundled into DRs which will then be listed in Hong Kong.

The availability of the DR structure can be instrumental in diversifying a listing market. For example, as discussed in 2.1.4, listings of Russian entities in the London market have been facilitated by the GDR option.

3.3.2 Listing requirements

Notably, the governing principle of the HDR project was that there would be no policy change in terms of basic market regulation. All the existing shareholder protections in the Listing Rules will apply to HDR issuers. Whether the issue takes the form of DRs or of ordinary shares, the issuer must comply with the same listing qualifications, including those regarding profit record, management and ownership continuity and public float, and the same ongoing obligations apply beyond listing.

We note and welcome the Listing Committee's plans to review the HDR system as an item on its policy agenda for 2014 and beyond.⁴²

⁴² The Listing Committee Report 2013.

Section 4 REVITALISE OVERSEAS COMPANY LISTINGS IN HONG KONG

Over the years the Hong Kong regulators have spared no efforts in the simplification and modernisation of market regulation, particularly in a number of procedural aspects. These will no doubt go some way towards further opening the Hong Kong market. However, to improve substantially Hong Kong's appeal to overseas companies, the Government and regulators should also consider the fundamentals underpinning the current listing framework, as well as issues in Hong Kong's broader legal and economic environment.

We have considered some key issues and will make a number of recommendations and observations. These recommendations, which we will discuss below in three categories, are summarised under Figure 4-1:

Category	Recommendation
<i>Procedural initiatives</i>	<i>Public filing safe harbours</i> – relax the public filing rules for overseas companies seeking a listing in Hong Kong
	<i>Price discovery</i> – conduct a general review of the Hong Kong IPO offering process to identify and remedy the key weaknesses to achieve optimal pricing
<i>Infrastructural initiatives</i>	<i>Cross-border regulatory enforcement</i> – strengthen mutual enforcement between Hong Kong and different countries of origination of listed companies
	<i>Shareholders' recourse</i> – explore and develop different channels for redress and compensation where loss is caused to shareholders due to corporate wrongdoing
	<i>Scripless system</i> – accelerate the implementation of a scripless holding system for listed securities
	<i>Double taxation agreements</i> – elevate the efforts in concluding double taxation treaties with other jurisdictions
	<i>Market segmentation</i> – consider a more rational segmentation of our listing market to enable different types of listed issuers and securities to be suitably matched with the appropriate types of investors

Development for specific industries – improve the “infrastructure” and underlying factors in building up Hong Kong as an attractive listing platform for mining companies and luxury brands

Corporate governance initiative *Diversification of legal structures* – open up the listing market to businesses in various legal forms (corporate or non-corporate), potentially with more diversity of holding and management structures

Figure 4-1: An overview of our recommendations

4.1 PROCEDURAL INITIATIVES: PUBLIC FILING SAFE HARBOURS

4.1.1 Issue

Under the new regime for Hong Kong listings introduced by the HKEx in July 2013 and effective as from 1 October 2013, two draft disclosure documents relating to a listing applicant will be required to be disclosed to the public via online publication, subject to certain transitional provisions and requirements as to redactions. These are (i) the version of the prospectus accompanying the listing application (the “**Application Proof**”) which under the rules must be a “substantially complete” document; and (ii) another version (the “post-hearing information pack” (or “**PHIP**”)) to be issued after the Listing Committee hearing and before issue of the “red-herring” (pathfinder) prospectus or commencement of book-building (whichever is earlier).

4.1.2 Impact on overseas companies listing

At the time of public consultation prior to the launch of the new rules, the impact of public release of disclosure documents, especially the Application Proof was the subject of much debate.

A key concern was that requiring listed issuers to disclose large amounts of information to the public before there is any assurance of its listing in Hong Kong may serve as a disincentive to issuers who may be justifiably wary about disclosing too much information in a public document (with little possibility of redactions, even for what may be regarded as “sensitive” business information) in the absence of deal certainty. The potential disadvantage to the attractiveness of Hong Kong as a market

may be more acute as the US, in the Jumpstart Our Business Startups Act 2012, took a move in the opposite direction.⁴³

During the consultation, the Hong Kong regulators were alerted to this potential problem. Whilst the regulators have in the finalised reforms opted for more transparency of information, they have also provided for a restricted safe harbour for public filing of the Application Proof for an applicant that has already been listed on a recognised overseas exchange for not less than five years and has a market capitalisation of not less than US\$400 million or such higher value as the HKEx may from time to time determine. No safe harbour applies to the publication of the PHIP.

Waivers or modifications may be sought from the HKEx, again for publication of the Application Proof but generally not the PHIP, by applicants who are spun-off from overseas listed parent companies. These will be determined on a case-by-case basis, taking into account a number of factors stated in related guidance issued by the HKEx.⁴⁴

4.1.3 Proposal – keep in view confidential filing safe harbours

Whilst the new IPO regime can be expected to go a long way towards enhancing information transparency in the Hong Kong listing application process, the potential dampening effect on the market should not be overlooked, particularly for overseas companies that do not have a natural geo-political “nexus” with the Hong Kong market and which may find other listing destinations more amenable to protecting confidentiality before there is deal certainty. The extent of the impact may not be apparent until some time has elapsed after the roll-out of the new IPO regime in October 2013.

⁴³ The Act permits qualifying “emerging growth companies” to file IPO registration statements on a confidential, non-public basis for initial review by the Securities and Exchange Commission. Under the system, an emerging growth company’s draft disclosure document and review correspondence with the Securities and Exchange Commission will be kept confidential until the registrant’s first public filing of its registration statement on EDGAR (the Commission’s public website), to which they will be attached as exhibits.

⁴⁴ HKEx-GL-57-13. Broadly speaking, these factors focus on whether the information about the proposed listing is price-sensitive to the overseas-listed parent entity, whether that entity is not required to disclose it under the rules of the place of primary listing, and whether that parent entity is able to keep the application for Hong Kong listing confidential.





As a short to medium term initiative, the Hong Kong regulators may keep this issue in view and re-assess the ambit of the safe harbour and the conditions for waivers or modifications to the requirements for public release of the Application Proof.

4.2 PROCEDURAL INITIATIVES: PLACING AND PRICE DISCOVERY MECHANISMS

4.2.1 Issue

Generally speaking, the share allocation and price discovery processes for Hong Kong IPOs are relatively inflexible compared with other advanced markets of the world. Some regulated aspects of these processes are in need of updating, while other, under-regulated, aspects can be improved by regulation.

Figure 4-2 compares certain key features of the IPO price discovery process in the Hong Kong, New York, London and Singapore markets. New York and London have a conspicuously shorter settlement cycle than Hong Kong, while Singapore's cycle is comparable to Hong Kong. See a more detailed discussion on this on Figure 4-4 below.

				
Retail Clawback	<ul style="list-style-type: none"> Clawback Mechanism⁽¹⁾ <ul style="list-style-type: none"> 15-49x retail subscription: 30% claw-back 50-99x retail subscription: 40% claw-back >100x retail subscription: 50% claw-back 	<ul style="list-style-type: none"> None 	<ul style="list-style-type: none"> None 	<ul style="list-style-type: none"> None
Retail Allocation	<ul style="list-style-type: none"> Based on the oversubscription Based on Listing Rules 	<ul style="list-style-type: none"> Typically 15-25% By syndicate discretion 	<ul style="list-style-type: none"> Typically 10-15% By syndicate discretion 	<ul style="list-style-type: none"> ~5% By syndicate discretion
Pricing Mechanism	<ul style="list-style-type: none"> Stringent pricing process Re-open retail process and re-file prospectus No flexibility 	<ul style="list-style-type: none"> Great flexibility Allow to be priced 20% up or below the range No additional filing required 	<ul style="list-style-type: none"> Modest flexibility No retail process File supplement prospectus if pricing outside the range 	<ul style="list-style-type: none"> Stringent pricing process Re-open retail process and re-file prospectus No flexibility
Free Float	<ul style="list-style-type: none"> 25% 	<ul style="list-style-type: none"> Not applicable 	<ul style="list-style-type: none"> 25% for premium listing 20% if the deal size > £500m 	<ul style="list-style-type: none"> Market cap < S\$300MM: 25% S\$300MM < Market cap < S\$400MM: 20% S\$400MM < Market cap < S\$1,000MM: 15% Market cap > S\$1,000MM: 12%
Trading Day	<ul style="list-style-type: none"> T+5 	<ul style="list-style-type: none"> T+1 	<ul style="list-style-type: none"> T+1 	<ul style="list-style-type: none"> T+6
Settlement Day	<ul style="list-style-type: none"> T+5 	<ul style="list-style-type: none"> T+3 	<ul style="list-style-type: none"> T+3 	<ul style="list-style-type: none"> T+6
Cornerstone	<ul style="list-style-type: none"> Formal Cornerstone Process Disclosure in Prospectus Guarantee Allocation 6-month lock-up 	<ul style="list-style-type: none"> No formal process 	<ul style="list-style-type: none"> No formal process 	<ul style="list-style-type: none"> No Lock-up Disclosure of names Individual investment size is not disclosed

Notes

- If the deal size is greater than HK\$10Bn, the issuer may apply for a waiver to reduce the retail tranche
- T = Pricing Date

Figure 4-2: Comparison of Hong Kong, New York, London and Singapore IPO price discovery process⁴⁵

⁴⁵ Morgan Stanley HKIPO Analysis 2014.

Figure 4-3 presents an overview of IPO aftermarket performance in recent years and the percentage of deals where the first-day trading price dropped below the IPO issue price. Generally, Hong Kong’s aftermarket performance lags somewhat behind London and Singapore, and significantly behind New York. While it is difficult to say precisely what factors have been causing this state of affairs, market experience is that the inflexibility of Hong Kong IPO price discovery process and the resultant constraints put on market participants are likely to have aggravated the situation.

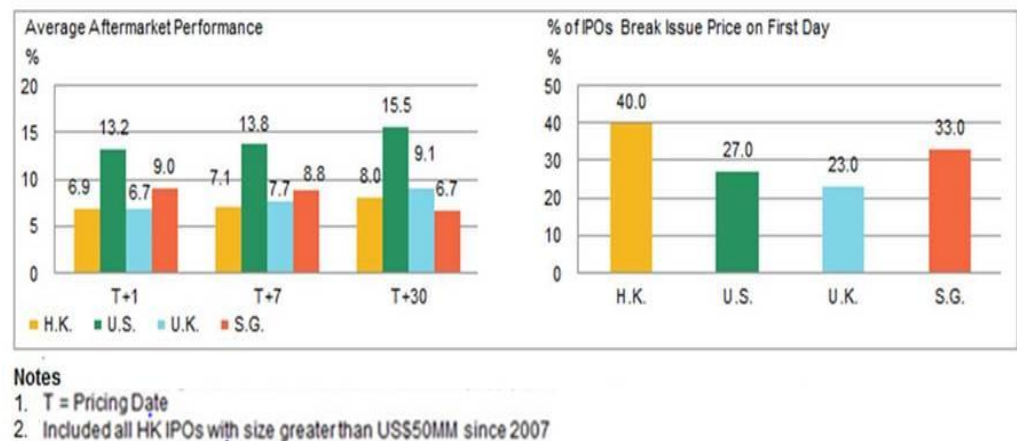


Figure 4-3: Hong Kong, New York, London and Singapore IPO performance overview⁴⁶

We highlight below some key inflexibilities we have experienced under the current regime.

- Mandatory retail offer

A typical equity listing with fund-raising on the Main Board of the HKEx comprises a retail tranche constituting 10% and an international (in practice, largely institutional) placing tranche constituting 90% of the offer size. A listing on the GEM Board may have a larger placing component and most GEM Board listings are achieved by way of placing only – i.e. without the participation of retail investors.

⁴⁶ Ibid.

Hong Kong is unusual amongst major international equity markets in that, in practice, there has to be a retail offer in virtually every IPO.⁴⁷ Although listing by way of placing continues to be technically possible under Chapter 7 of the Listing Rules, in recent years a Main Board IPO without a retail tranche has become extremely rare.⁴⁸

As illustrated in Figure 4-2, the mandatory clawback from the international placing tranche to the retail tranche is unique to Hong Kong and, to some extent, predisposes Hong Kong toward the lower end of the spectrum of flexibility in deal-structuring.

In the Listing Rules⁴⁹ the HKEx specifically reserves power not to permit a professionals-only offering if there is likely to be significant public demand. The policy rationale behind this is to ensure that retail investors have a fair opportunity to participate in an IPO. This is a legitimate regulatory concern. Apart from promoting the fairness and openness of the market, retail participation supports the building of demand in the IPO and contributes to the liquidity in the shares post-listing.

In the meantime, however, we believe it is important for the Hong Kong market to have a measure of built-in flexibility. It is acceptable, indeed desirable, to ensure a minimum level of retail participation where an IPO proposal features suitable economics and deal mechanics. Nevertheless, there may be ways in which the market can accommodate transactions and issuers that do not suit a typical retail investment profile – for example, issuers with a high-risk business or corporate profile, or proposed deal structures that do not give all of the normal protections to investors equally.

⁴⁷ Except listings of collective investment schemes under Chapter 20 and investment companies under Chapter 21 of the Listing Rules, and listings on the GEM Board.

⁴⁸ In the past decade, listings by placing have all but disappeared except for investment companies and some unusual or specifically negotiated cases, such as the 2000 listing of Star Cruises Limited (renamed as Genting Hong Kong Limited, by placing and introduction) and the 2010 listing of United Company RUSAL Plc. A large number of IPOs on the GEM Board, however, are by way of placing only.

⁴⁹ Paragraph 4.1 of Practice Note 18.

We believe that, to a prospective IPO with unusual features that are potentially not optimum for the Hong Kong retail market, our market need not respond too hastily by rejecting it on the basis of a stringent application of the rules. As we have seen in some past examples⁵⁰, our market does have a history of accommodating some unusual issuer or deal features that render a transaction unsuitable for retail participation, if the regulators were satisfied that the listings would be in the best interest of the market as a whole. Provided there are genuine business or legal reasons for the unusual features and that appropriate safeguards are made, the regulators may consider broadening such flexibilities for appropriate transactions and issuers. There is at present plenty of scope for the regulators to work together with stakeholders to achieve the right balance between market integrity and competitiveness.

As discussed further in section 4.7 below, some of the regulators' concerns regarding fair treatment of the retail market may be more appropriately addressed by market segmentation, rather than relying on the current requirement for a mandatory retail offer tranche for every IPO on the HKEx Main Board. If the regulators and market stakeholders are together able to find a way to introduce more flexibility without compromising the protections and opportunities to retail investors, it would contribute materially to putting Hong Kong on par with other advanced markets of the world, with issuers being given more freedom to structure their deals in response to changing needs and circumstances.

- Fixed clawback mechanism

The Listing Rules⁵¹ provide that, where an IPO includes both a placing tranche and a public subscription (i.e. retail) tranche, the minimum allocation of shares to the subscription tranche must be managed in the following way:

⁵⁰ See footnote 48.

⁵¹ Paragraph 4.2 of Practice Note 18; there is no mandatory retail tranche requirement for listings of authorised collective investment schemes under Chapter 20 and investment companies under Chapter 21 of the Listing Rules.

- an initial allocation of 10% of the shares offered in the IPO;
- a clawback mechanism that increases the number of shares to 30% when the total demand for shares in the subscription tranche reaches 15 times but is less than 50 times the initial allocation;
- a clawback mechanism that increases the number of shares to 40% when the total demand for shares in the subscription tranche reaches 50 times but is less than 100 times the initial allocation; and
- a clawback mechanism that increases the number of shares to 50% when the total demand for shares in the subscription tranche is 100 times or more the initial allocation.

Devised more than 15 years ago, these mandatory clawback provisions are in need of reconsideration, particularly in terms of (i) the relationship between the size of the mandatory clawback and the over-subscription for the deal and (ii) any possibilities of fine-tuning to cater for specific circumstances, other than the current route of specifically applying for waivers or modifications from the HKEx.

The clawback provisions seek to ensure that issuers and deal managers do not excessively favour institutional investors at the prejudice of retail investors, which is a legitimate regulatory concern. There is, however, an inherent risk in rules that favour (or even mandate) IPO allocation to retail investors. International market professionals broadly agree that some retail investors are relatively more prone to short term trading and may dispose of their shares shortly after the IPO, thereby creating immediate downward pressure on the share price and a volatile aftermarket.

- Long settlement cycle and negative effect on pricing

In a Hong Kong IPO, there is typically a gap of about five days between determination of the offer price and commencement of trading of the shares on the HKEx.

Hong Kong's T+5 settlement cycle is largely due to specific limits imposed by Hong Kong Securities Clearing Company Limited

("HKSCC"), the operator of the Central Clearing and Settlement System. A summary of the key processes of the public share registrar and HKSCC during the five day interval is as follows:

Day 1: close of retail offer subscription lists, price determination and overnight clearing of cheques accompanying applications

Note: the one business day for clearing cheques through the Hong Kong banking system cannot be shortened

Day 2: processing of bounced cheques and invalid applications, preparation of final basis of allotment for confirmation by the global coordinators and bookrunners

Day 3: submission of CD containing details of allotment and refund for applications through the "eIPO" system to HKSCC

Note: under HKSCC requirements this must take place before 10 a.m. on the date before the date of sending refund cheques to retail applicants

Day 4: dispatch of refund cheques and share certificate

Note: under current practice, the share certificates must be issued on the day before public trading

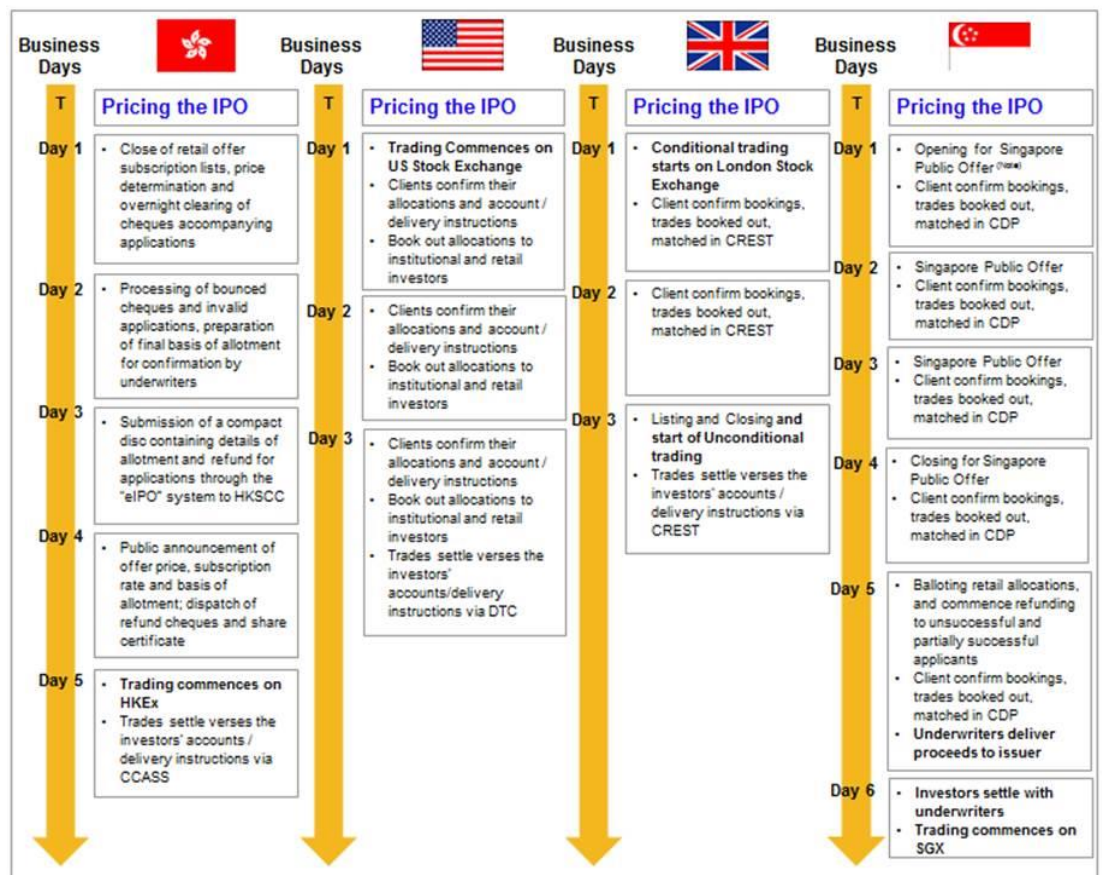
Day 5: Trading commences on the HKEx

This settlement cycle imposes a comparatively long exposure to the listing applicant as well as the underwriters. This can be very significant in a volatile market and will be factored into the pricing, most likely by way of downward adjustments. This is rather unsatisfactory compared to other markets where the price discovery process is less affected by extraneous circumstances and more truthfully reflects the company's valuation.

In contrast, some markets of the world accommodate "when-issued" trading⁵² after an IPO has been priced. In the US, for

⁵² Trading of securities that have been authorised but not yet issued, whereby the underwriters solicit interest from investors and orders are made conditional on the final issue of the securities.

example, trading can effectively take place on a “when-issued” basis shortly after the registration statement with the Securities and Exchange Commission is declared effective (which typically coincides with the end of marketing) and the final price has been determined. See Figure 4-4 for a comparison of the settlement cycles of Hong Kong, London, New York and Singapore. Typically, the London and New York settlement cycles are significantly shorter while the Singapore one is comparable to Hong Kong⁵³. Settlement processes such as balloting, refund cheques, etc. typically take one to two days in Singapore and a minimum of five days in Hong Kong.



Note:
Singapore Public Offer's subscription period open through weekend

Figure 4-4: Hong Kong, New York, London and Singapore settlement⁵⁴

⁵³ There are different modes of conducting a public offer in Singapore. Figure 4-4 describes a typical transaction where the IPO price is fixed before the public offer opens. In this example, the settlement period is T+6 including the three days of public offer. A public offer may also be launched on the basis of an indicative price range, in which case the settlement period (commencing from fixing the IPO price) can be as short as T+4.

⁵⁴ Morgan Stanley HKIPO Analysis 2014.

- Cumbersome price adjustment mechanism

Where difficult market conditions necessitate a revision of the offer price, the HKEx imposes certain procedures⁵⁵ regarding public disclosure (including a mandatory supplemental prospectus with attendant legal requirements as to contents, translation and registration) and specific mechanisms to allow investors to withdraw their applications for IPO shares. These provisions have unfortunately resulted in difficulties particularly in volatile market conditions, with little maneuvering room given to issuers and their advisers.

While some of the current regulations may be desirable or even necessary to protect public investors who have parted with funds when applying for IPO shares, the downside is that the inflexibilities will be reflected in the pricing of deals and will depress the performance of our IPO market as a whole. To achieve a better balance of these factors, the regulators may consider modernising the rules and seek ways to introduce more flexibilities gradually into the system.

- Under-regulation of cornerstone investment

Cornerstone investment is a process whereby one or more investors commit to taking up a portion of the shares in the placing tranche at the IPO price before the IPO is launched, giving the investor(s) the benefit of guaranteed allocation in exchange of a non-disposal undertaking (typically of six months' duration). In recent years, cornerstone investment has become an increasingly important part of the Hong Kong IPO process. Cornerstone investments of a combined size exceeding 70% of a global offering are not unheard of.⁵⁶

Historically, cornerstone investors played an important role in the success of transactions in volatile markets. Figure 4-5

⁵⁵ HKEx-LD-86-1.

⁵⁶ The November 2011 (re-launched) IPO of China Outfitters Holdings Limited (1146.HK) included three cornerstone investments that made up 75.65% of the offer size and 15.27% of total issued capital.

illustrates cornerstone investment trends in Hong Kong IPOs in the past few years and the average sizes of such investments.

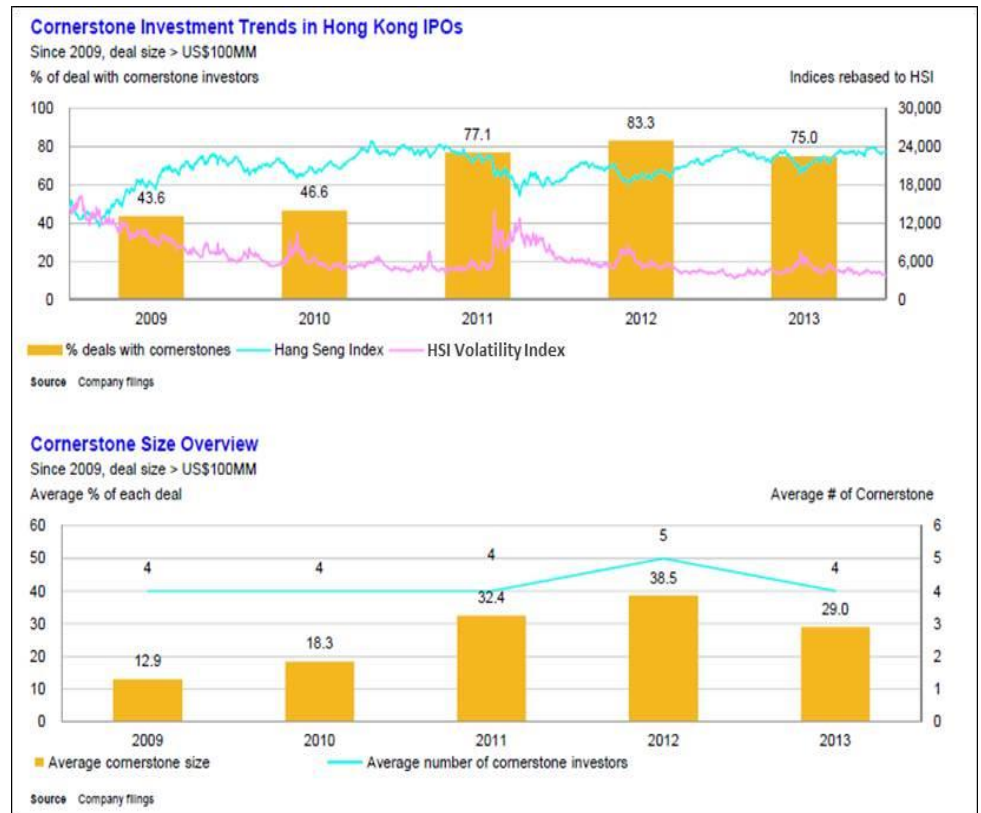


Figure 4-5: Cornerstone investment trends in recent Hong Kong IPOs⁵⁷

One undesirable side effect of IPO cornerstone investment is that it takes the pricing process further away from the normal market forces and may have a distortive effect on the company’s market value.

In sluggish market conditions, the success of an IPO often hinges on the ability of the deal managers and the listing applicant to attract cornerstone investors. Some listing applicants would tie underwriters’ remuneration to the amount of cornerstone investment secured, thus providing financial incentive to deal managers in a “race for cornerstone investors” and further detaching the IPO process from the normal rules of market supply and demand for the shares and valuation of the company’s business.

⁵⁷ Morgan Stanley HKIPO Analysis 2014.

The lock-up (typically of a six-month duration) on disposals by cornerstone investors also means there is an “overhang” of untradeable shares in the market which reduces liquidity. There is also a wider conceptual issue here, namely the inherent tension between the existence of a large and illiquid “overhang” and the concept of a minimum public float which is a key principle of the Hong Kong market.

Figure 4-6 illustrates the impact of cornerstone investments in recent Hong Kong IPOs. The aftermarket performance of companies with a significant cornerstone component in their IPOs often proves to be sub-optimal. In particular, for recent IPOs with cornerstone tranches that take up more than 50% of the offer, the stocks have underperformed the market. This figure also illustrates that, owing to “overhang” concerns, trading price usually shows higher volatility around the expiration of the cornerstone investors’ lock-up.

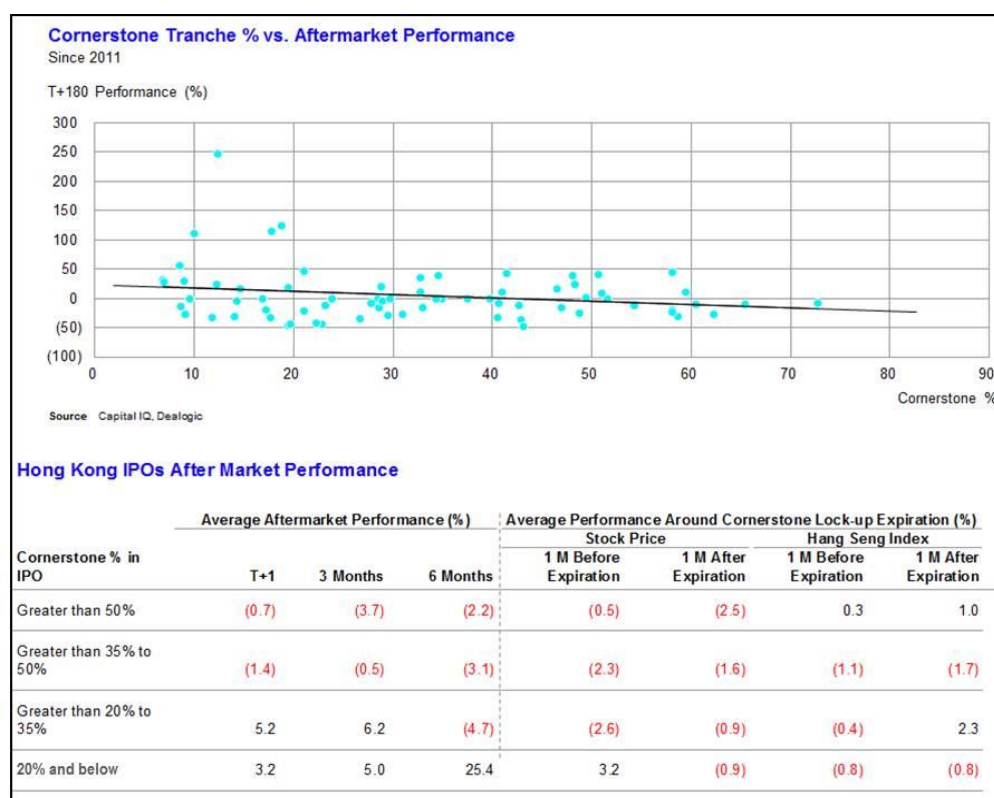


Figure 4-6: Impact of cornerstone investment on Hong Kong IPOs⁵⁸

⁵⁸ Ibid.

- Inadequate guidance on placing and allocation

Generally, most IPO practitioners agree that the Placing Guidelines for Equity Securities in Appendix 6 to the Listing Rules (“**Placing Guidelines**”) are no longer up to date and require improvement. There are many areas of uncertainty and the current practice of supplementing the rules by ad hoc guidance such as HKEx listing decisions and guidance letters contribute to a truncated and piecemeal approach.

4.2.2 Impact on overseas companies listing

The problems and inflexibilities we have examined above in the Hong Kong IPO placing and price discovery processes do not affect only overseas companies but all listing applicants.

However, the problem could be more acute in the case of overseas companies that do not have a natural nexus with Hong Kong. In such a case, aspects of the Hong Kong market that are not conducive to market efficiency and accurate pricing may have a significant dampening effect. Overseas issuers may favour other markets that showcase a more rational pricing process which gives investors confidence that the issue price is less driven by extraneous circumstances than by traditional factors such as the company’s asset value, profitability, business prospects, future trends and general market dynamics.

4.2.3 Proposal – short and long term initiatives

In the short term, we believe the regulators may consider two initiatives to improve this aspect of the market:

- The current practice on cornerstone investments, insofar as it tends to obstruct a “genuine” book-building process, can be doing the market a disservice even as it appears to facilitate the launching of an IPO. Priority should be given to a review of the cornerstone investment landscape, with a view to providing a well-considered regulatory regime for this important aspect of a Hong Kong IPO.
- The regulators may also consider introducing more flexibility to the clawback requirements. This may initially involve codifying

and clarifying existing practice of granting waivers to companies with large capitalisations.

Much of the IPO settlement and pricing process is currently regulated by way of rules, guidance letters, ad hoc waivers and similar administrative practices. Pending a wholesale review of the underlying principles, we encourage the regulators to focus as soon as possible on key practical aspects that can be significantly modernised without extensive consultation, legislative or rule-making processes.

The Listing Committee has recently indicated its intention to review the Placing Guidelines as an item on the policy agenda for 2014 and beyond.⁵⁹ We are encouraged by this and look forward to engaging with the HKEx and public stakeholders in the relevant discussions.

Over the medium to long term, regulators should keep in view the Hong Kong IPO price and settlement mechanics and consider appropriate reforms from time to time in order to maintain the quality of our market. In this connection, we stress that the authorities should look out for ways in which technology may help us find ways to ensure fair and efficient IPO price discovery. For example, we note that last year the Australian Stock Exchange launched a computerised book-building facility available to its participants.⁶⁰ This is an additional tool to assist brokers and investment banks in relation to the pricing and allocation of securities. Hong Kong should consider how similar types of technological processes may help us develop our market.

4.3 INFRASTRUCTURAL INITIATIVES: CROSS-BORDER REGULATORY ENFORCEMENT

4.3.1 Issue

The ability to enforce shareholders' rights is crucial to the protection of public shareholders. To any shareholder seeking redress against a wrong done to them via a breach of securities law or regulation, there are two main issues: (i) having access to the management of the company; and (ii) having access to the company's assets through legal

⁵⁹ Listing Committee Report 2013.

⁶⁰ See the ASX BookBuild Issuer Information Sheet:
<http://www.asx.com.au/documents/professionals/bookbuild-issuer-information-sheet.pdf>

enforcement. In both of these aspects, unique challenges are posed by overseas companies which are beyond the reach of the long arm of Hong Kong law. The regulators employ two techniques in addressing such concerns:

- Ensuring shareholder protection standards in the jurisdiction where the company was incorporated

Hong Kong's regulatory regime focuses on the country of incorporation. This is because voting, dividends and other shareholders' rights are typically embodied in the company law of the country of incorporation. The weakness of this approach is that the country of incorporation may have nothing to do with the company's business, e.g. a Jersey company operating mines in Africa. If legal enforcement is not viable at the place of principal business, a theoretical right of enforcement at the country of incorporation has little meaning.

Under the system that pre-existed the 2013 JPS, the HKEx's response to this problem was to impose a "nexus requirement": jurisdictions of incorporation which demonstrate only a distant nexus between the applicant's place of incorporation and its business operations may be subject to greater scrutiny by the HKEx.

With the introduction of the 2013 JPS, the nexus requirement was replaced by the international regulatory cooperation arrangements described in 3.1.4(B). It remains to be seen whether cross-border regulation will prove adequate to protect Hong Kong public shareholders' rights and interests.

- Bilateral enforcement agreements

In order to determine whether a breach of a Hong Kong law or regulation by an overseas company that does not have personnel or assets in Hong Kong is realistically actionable by shareholders in Hong Kong who have suffered loss, there are at least three factors to consider: (i) whether the relevant breach (potentially being a provision of Hong Kong law, a HKEx regulation or an undertaking given to the HKEx) will be deemed a breach of law or

rules in the company's home jurisdiction; (ii) if there are formal cooperation mechanisms between the local and Hong Kong regulators over matters such as the exchange of information, assistance in investigation and the commencement of proceedings; and (iii) if there are mutual enforcement regimes in place which enable the reciprocal recognition between Hong Kong and the relevant country of judgments and sanction orders obtain in either jurisdiction.

Accordingly, a practical factor that the HKEx views favourably when considering applications from overseas companies is whether the applicant is incorporated in a jurisdiction of which the statutory securities regulator has adequate arrangements with the SFC for mutual assistance in the above matters either by way of the IOSCO MMOU⁶¹ or an adequately comprehensive bilateral agreement with the SFC.

4.3.2 Proposal – more international enforcement cooperation

The assurance given by an IOSCO MMOU signed between Hong Kong and the relevant overseas country of incorporation appears to be working well and the Hong Kong regulators are to be commended for their continuing efforts over the years.

Going forward, we believe the regulators may explore additional ways to expand Hong Kong's "regulatory reach" by means of reciprocal enforcement or cooperation arrangements with key territories, particularly countries of origination of companies that are potentially most attractive to our market.

The Hong Kong regulators may also consider stepping up its efforts in enhancing international cooperation in enforcement, for example by signing MOUs with more countries or entering into other forms of agreement to facilitate exchange of information and coordinated action. The process can commence in the short to medium term.

⁶¹ See footnote 29.

4.4 INFRASTRUCTURAL INITIATIVES: SHAREHOLDERS' RECOURSE

4.4.1 Issue

Historically, breaches of securities or company laws causing loss to public shareholders are seldom litigated in Hong Kong. This is caused by a combination of several factors including (i) the absence of any laws or regulations permitting or governing collective litigation (such as US-style class actions); (ii) the rule against contingency fee charged by lawyers; and (iii) the absence of any realistic litigation funding alternatives for shareholders.

4.4.2 Impact on overseas companies listing

The relatively limited channels of shareholders' recourse in Hong Kong and the scarcity of Hong Kong court cases on misconduct affecting public shareholders mean that Hong Kong investors may not have the same tools available to their counterparts in the US or other more litigious markets to seek redress in court or other tribunals against wrongs done to them by listed companies.

Over the years, this has motivated Hong Kong's regulators to take a more "front-end" approach to regulating listing applicants and listed issuers. Prospectus and circulars are pre-vetted and cleared by the regulators who produce a large number of checklists, detailed guidance notes and other materials to aid compliance. By way of an example, issuers and their advisers are practically taught how to write their prospectuses by way of a large number of HKEx guidance letters, listing decisions and frequently asked questions.

While in recent years there have been numerous attempts by both the HKEx and the SFC to shift the compliance burden to issuers and to put more efforts on subsequent enforcement (e.g. the move from pre-vetting to post-vetting of certain documents), in so far as IPOs are concerned, the regulators remain very closely engaged with issuers and their IPO sponsors at the preparatory stage, to ensure the right levels of disclosures are made and all the rules are complied with.

As a corollary to this regulatory approach, overseas companies seeking a listing in Hong Kong tend to be, or perceive themselves of being, "screened" by the regulators in accordance with the JPS and ancillary

rules. The regulators cannot relinquish their role as gatekeepers as long as public shareholders look to them to uphold market standards. This is an understandable, but potentially unsatisfactory, state of affairs, as shareholders often do not have any meaningful way to pursue their own claims against the wrongdoing of a publicly listed company that has caused losses to them.

At this stage, however, without the benefit of more in-depth study, we are not necessarily committed to the position that the Hong Kong market would be materially improved by becoming made “more litigious”.

4.4.3 Innovative and proactive uses of ss.212 – 214 SFO orders

We are encouraged by the SFC’s efforts in defending the integrity of our market. In recent years, the regulator has repeatedly broken new ground by conducting “surrogate” actions for private compensation, relying on various powers given under ss.212 – 214 of the Securities and Futures Ordinance (Cap. 571) (“SFO”).

A recent case involving s.212 was China Metal Recycling, a Cayman Island company with a PRC-based business. A few years after its IPO, SFC investigations revealed that the company might have overstated its financial position in its prospectus and annual report. The SFC made a first case of its kind when, invoking s.212, it applied in 2013 to the court for an order to wind up the company to protect the interests of shareholders and creditors, as well as the investing public. The court granted provisional liquidators extensive powers to investigate and manage the company’s affairs. At the date of this paper, the case continues.

Section 213 allows the SFC to seek an order from the High Court to unwind transactions in breach of the SFO, amongst other reliefs, to remedy the loss of individual investors. Its effectiveness was demonstrated in a number of impressive examples:

- Hontex International, a Cayman Islands company with a PRC-based business, made false and misleading representations in its prospectus. Pursuant to s.213, the SFC obtained an interim order to freeze the issuer’s assets. It further obtained another order for

a shareholders-approved, court-administered HK\$1.03 billion scheme to buy back the shares. Individual investors were saved the trouble and costs of commencing proceedings themselves.

- Qunxing Paper, a Cayman Islands company with a PRC-based business, was suspected of having made materially false and misleading statements in its prospectus and annual results announcement. In 2013, the SFC successfully obtained an interim injunction to prevent dissipation of assets of up to HK\$1.968 billion pending the close of investigations and resolution of the case.

Section 214 empowers the court, on petition by the SFC, to grant a variety of orders where a listed corporation's business or affairs have been conducted in a manner oppressive or unfairly prejudicial to its members, or involving fraud or other misconduct. The SFC has carried out a number of successful enforcement actions on this provision.⁶²

4.4.4 Observation

The Hong Kong regulators have shown commendable commitment to enforcing securities laws and regulations. We applaud the results so far.

Although the Hong Kong Law Reform Commission has recommended a class action regime starting with consumer cases by establishing a Consumer Legal Action Fund⁶³, at the date of this paper it remains uncertain when class action will be available to Hong Kong consumers, let alone securities investors. It is all the more important therefore that our regulators continue to enforce securities laws and regulations in time-tested as well as innovative ways.

In the meantime, the authorities should keep in view prospects for shareholders seeking direct redress against corporate wrongdoing. As a long term project, giving shareholders more tools to enforce their own rights will likely remove the need for much of the current front-end regulatory scrutiny of overseas issuers, thereby giving a significant

⁶² For example, compensation orders against the former chairman and executive director of Styland Holdings Limited in (SFC v Kenneth Cheung Chi Sing [2010] HKCU 2560) and the former CEO of China Asean Resources (SFC v Li Wo Hing [2012] HKCU 2104).

⁶³ "Class Actions (Report)", The Law Reform Commission of Hong Kong, May 2012.

impetus in the growth of Hong Kong as a destination for cross-border listings.

Equally if not more important is that a genuine prospect of shareholders' action is likely to improve investors' confidence in Hong Kong as a sophisticated international securities market.

4.5 INFRASTRUCTURAL INITIATIVES: UNCERTIFICATED SECURITIES HOLDING SYSTEM

4.5.1 Issue

Nowadays, investors mostly transfer HKEx-traded shares through the Central Clearing and Settlement System ("**CCASS**") operated by HKSCC.

The current version of CCASS is a semi-scripless securities holding and settlement system, which requires a global share certificate to be issued by the listed issuer and deposited with the CCASS. All shares deposited with CCASS are registered in the name of HKSCC Nominees Limited ("**HKSCC Nominees**") and transfers of beneficial interest in the underlying shares take place without any alteration in the registered legal title, until the shares are taken out of the system. Because HKSCC Nominees acts as registered shareholder of all shares deposited with the CCASS, the listed issuer does not know the identities of the underlying shareholders. Corporate communications with underlying shareholders are made, and voting and other shareholders' rights are exercised, indirectly, either (i) via an intermediary (e.g. a broker or an investment bank) which may be the interface between CCASS and its client, or (ii) by any instructions that the beneficial owner of the shares (if he holds an investor participant's or other appropriate HKEx trading account) may happen to pass to HKSCC Nominees for forwarding to the company's share registrar.

In the case of voting, the current holding structure has necessitated a somewhat anomalous route of communication: If the beneficial owner of the share wishes to vote at the company's general meeting, the typical way to achieve this is for HKSCC Nominees to appoint the owner as proxy. While this has not caused significant problems in the past, requiring the ultimate owner of shares to apply to become the settlement agent's proxy in order to vote on his own shares is highly contrived and counter-intuitive. It is also potentially problematic as a

matter of law, as the company law (which may differ significantly depending on the legal system governing each listed company) applying to any given listed issuer may give proxies certain rights and obligations that are different from those of a registered shareholder.

4.5.2 Impact on overseas companies listing

The requirement that a global share certificate must be deposited with a central depository creates problems for companies from countries with an uncertificated (or “scripless”) securities holding and trading environment – companies from some jurisdictions are legally unable to issue a share certificate. For these companies, listing by way of HDR may be the only convenient option.

As discussed in section 4.2.1, the paper-based settlement and clearing environment in Hong Kong (with such features as physical share certificates and refund cheques that have to be mailed to IPO subscribers) also causes inefficiencies in price discovery.

The discussion above regarding proxy voting highlights the discomfort with which the market has made do with an artificial environment for voting on shares that are traded and settled through CCASS. This discomfort can be alleviated or even eliminated upon a more rationalised uncertificated system, on which the Hong Kong regulators have devoted much commendable effort.

4.5.3 Proposal – implement uncertificated shareholding system

The move towards an uncertificated system has been proposed a number of times in the past decade. The SFC issued a consultation paper as early as February 2002 (which was concluded in 2003) and the following year, the HKEx also issued a consultation paper followed by conclusions in 2004.

The matter matured further in a more recent joint consultation conducted by the HKEx, SFC and Hong Kong Federation of Shares Registrars Limited, issued in December 2009 and concluded in 2010⁶⁴, in which a uncertificated securities market in Hong Kong was

⁶⁴ “Joint Consultation Conclusions on a Proposed Operational Model for Implementation of a Scripless Securities Market in Hong Kong”, the HKEx, SFC and Hong Kong Federation of Share Registrars Limited, 21 September 2010.

recommended and some of the practical details were set out. The proposals will involve a number of law and regulatory reforms, including amendments to a number of primary and secondary legislation.

We are greatly encouraged by the latest joint Government / SFC proposal, released in late 2013, putting forward for public consultation the legislative amendments. We understand that the Bill will be introduced into the Legislative Council in late June 2014 and eagerly await further developments.

4.6 INFRASTRUCTURAL INITIATIVES: REDUCING THE TAX IMPACT OF OVERSEAS COMPANY LISTINGS

4.6.1 Issue

Hong Kong may or may not have a double taxation agreement (“DTA”) or other tax arrangements with the jurisdiction of incorporation of any particular overseas company considering a Hong Kong listing.

4.6.2 Impact on overseas companies listing

Taxes and levies in overseas jurisdictions may render investment in companies from those countries relatively expensive for Hong Kong shareholders. This is illustrated by the listing of Prada S.p.A.. At the company's Hong Kong debut in 2011, whilst its offering for institutional investors had been five times over-subscribed, demand from local retail investors was tepid because of tax concerns. As Italy and Hong Kong do not have a DTA, according to the company's disclosure document its Hong Kong shareholders are potentially liable to a 12.5% capital gains tax.

The problem is aggravated by the CCASS settlement system. As explained in section 4.5.1, since the issuer must ascertain who the underlying shareholders are and determine their exemption status, it may not be possible for the issuer to apply for exemptions or other relief on behalf of Hong Kong investors. In the case of Prada S.p.A., the company must make a withholding on dividend at the full 27% although certain shareholders may have qualified for exemption or relief, had the company been able to gather information about them.

Figure 4-7 sets out two case studies where local taxes and levies could have a significant adverse impact on the economic performance of the investment to Hong Kong shareholders:

Company	Tax scheme in the overseas jurisdiction ⁶⁵
Prada S.p.A.	Italian tax chargeable upon disposal of shares: <ul style="list-style-type: none"> (i) 12.5% tax for sale of non-substantial holding (ii) Up to 43% tax for half of the sale of a substantial holding (iii) 27% withholding tax on dividends
Mando China Holdings (stalled IPO)	<ul style="list-style-type: none"> (i) Up to 22% Korean withholding tax on dividends and capital gains (ii) 0.5% securities transaction tax

Figure 4-7: Examples of companies subject to capital tax schemes in original jurisdictions

4.6.3 Proposal – step up DTAs

Some categories of taxes (e.g. stamp duty and other levies on documents) are outside the typical ambit of tax treaties. In terms of tax categories that can potentially be addressed by international cooperation, Hong Kong has been making progress in its effort to form DTAs with its trading partners. Twenty-nine comprehensive DTAs have been concluded by Hong Kong as of July 2013.⁶⁶ If efforts can be stepped up over the medium to long term, overseas company IPOs are likely to have a much warmer reception by Hong Kong investors.

4.7 INFRASTRUCTURAL INITIATIVES: MARKET SEGMENTATION

4.7.1 Issue

There is little segmentation in the Hong Kong listing market as there are only two markets, namely the Main Board and the GEM Board. The performance of the GEM Board has been erratic over the years. Debt

⁶⁵ This description of tax categories and rates is based on the companies' IPO prospectuses and reflects the position as at the dates of the prospectuses, as ascertained by the companies and their advisers.

⁶⁶ "Comprehensive Double Taxation Agreements Concluded", Inland Revenue Department.

listings⁶⁷ have been under-utilised until the introduction of a new professionals-only debt listing regime⁶⁸ in November 2011. As a result, the focus of the Hong Kong IPO market has always been on equity offerings on the Main Board, which is governed by a single set of rules. To date, the regulators have applied rules that are, generally speaking, retail-oriented, as is evident from the regulations governing prospective disclosure and marketing rules, any deviations of which must be specifically applied for by way of a waiver.

4.7.2 Impact on overseas companies listing

As observed in section 4.2.1 above, in a typical Hong Kong equity IPO, only 10% of the securities issued are offered to the retail market, with the remaining 90% to be taken up by institutional and other professional investors, subject to the clawback mechanism imposed under the Listing Rules which may increase the retail segment according to a fixed formula if the IPO is oversubscribed.

A recent HKEx study shows that, during the year 2012-13, domestic retail investors accounted for 18% of total participation in the listed securities market, with overseas retail investors accounting for another 5%: See Figure 4-8.

While the actual participation of retail investors in an Hong Kong IPO often remains in the minority (unless there is a high demand for the shares triggering the clawback mechanism), the concern is that by applying, in all cases, regulations which demand the highest investor protection standards (typically at increased compliance cost to the issuer), the Hong Kong IPO market as a whole risks losing flexibility and competitiveness. The highest levels of compliance is often not strictly necessary for institutional investors who are in many advanced markets taken as “big boys” (i.e. more skilled in spotting and managing risks in investments and selecting products that suit their investment needs). These investors, after all, accounted for over 60% of the cash market’s trading in 2012-13 and typically up to 90% of the total take-up in an IPO. Overseas companies with an eye for sophisticated and strategic

⁶⁷ Under Chapter 22 of the Listing Rules.

⁶⁸ Under Chapter 37 of the Listing Rules.

investors may find compliance with these “one-size-fits-all” regulations both cumbersome and irrelevant and may, as a result, be diverted to other markets that are more able to meet their profiles.

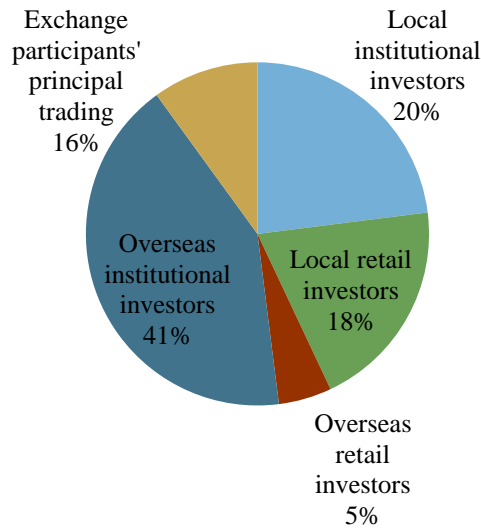


Figure 4-8: Distribution of overall investors⁶⁹

4.7.3 Comparison with other global exchanges

As a comparison, we have taken a look at a few overseas markets.

London Stock Exchange (LSE): The LSE consists of four different markets. The Main Market, the London equivalent of our Main Board, is further divided into three segments. All segments are governed by a different set of rules. Figure 4-9 is an at-a-glance presentation of market segmentation of the LSE:

<u>Segment</u>	<u>Features</u>
Main Market (Premium)	Equity shares issued by trading companies and investment entities; regulation is higher than EU minimum requirements; issuers enjoy lower cost of capital.
Main Market (Standard)	Issuance of equity shares, GDRs, debt securities and securitised derivatives; regulated by EU minimum requirements.

⁶⁹ Cash Market Transaction Survey 2012/13, HKEx, February 2014.

Main Market (High-Growth Segment (“HGS”))		High-growth, revenue generating businesses incorporated in a European Economic Area (“EEA”) state that are aspiring to join the Premium segment; regulated by EU minimum requirements and LSE’s HGS rulebook.
Alternative Market	Investment	Smaller growing (e.g. early stage, venture capital-backed) companies from any country and any industry sector.
Professional Market	Securities	Issue of specialist securities (e.g. debt and GDRs) to professional investors; issuers bypass the retail or equity regime; no IFRS financial reporting.
Specialist Fund Market		Market for specialist investment funds, targeting institutional, professional and highly knowledgeable investors.

Figure 4-9 : Segmentation of the London listed equity market

Singapore Stock Exchange (“SGX”): According to one report⁷⁰, the SGX’s “Asian Gateway Policy” has demonstrated a measure of success in enticing companies from the Asia Pacific region to become listed on the SGX, including a substantial number of “S-Chip” companies (a name informally used by the SGX to denote companies incorporated in the PRC). In 2010, the SGX boasted not less than 156 S-Chip listings with a total market capitalisation of approximately US\$31 billion. However, many of these companies may have been unable to go public on the HKEx, being pushed out by larger state-owned PRC companies that were completing larger IPOs in Hong Kong at the time.

Australian Securities Exchange (“ASX”): The amendments to the Corporations Act 2001 (Cth) and the ASX Listing Rules in 1999 enabled small and unprofitable companies to list on the ASX as Commitments Test Entities (“CTEs”). The scheme allows entities which fail to satisfy the listing requirements under the general admission criteria to list as a CTE provided that it reaches a consensus with the ASX regarding the use of the proceeds raised from the IPO listing.

⁷⁰ “Singapore Stock Exchange’s “Asian Gateway” Policy Attracts Listing by Foreign Companies”, Friedland Capital News.

Empirical evidence suggests that the CTE regime provides increased opportunities for investors to invest in small-cap companies and enables small and young IPO companies to raise equity finance at reasonable costs. Whilst longer term stock underperformance has been worse for CTE IPOs when compared to other IPOs, there is little difference in short term investor returns of CTE IPOs. Further, the track record of CTE IPO companies indicates that they are not more likely to de-list because of financial distress or bankruptcy.⁷¹

4.7.4 Proposal – reassess “one-size fits all” regulation

Over the medium to long term, our “one-size-fits-all” approach to market regulation in the IPO space may be reassessed. Appropriate segmentation should be considered as one possible way to open up the market to investors with different risk appetites and issuers with different profiles. In particular, differentiation of the market according to the level of investors’ experience and risk appetite will allow reputable large-cap companies to list with more compliance flexibility, as well as offering an opportunity to companies with small capitalisations which do not fulfill the general listing requirements to consider Hong Kong as a listing venue.

Notably, market segmentation involves not only segmentation of the IPO market but also of the secondary trading market. In other words, while appropriate listing requirements will be devised for different categories of listing applicants, there must also be appropriate ring-fencing between the trading platforms of these segments to suit investors’ profiles.

4.8 INFRASTRUCTURAL INITIATIVES: A HUB FOR SPECIFIC INDUSTRIES

4.8.1 Background

The HKEx is an attractive listing destination for companies belonging to industries which are in a position to benefit from the Chinese economic boom. As illustrated in Figure 4-10 below, the luxury goods and retail sector has been one of the top Hong Kong IPO performers in terms of

⁷¹ “ASX Small Firm Listing Concessions: How Have They Worked?”, Zoltan Murgulov, Australian Centre for Financial Studies, 3 May 2012.

capital raised in recent years. Energy and natural resources is another sector which showed strong growth potential in the past decade. This is largely due to the significant demand for these commodities in the Chinese market and the robust overseas expansion plans of PRC mining companies in countries such as Australia, Brazil and Canada. The HKEx's successful acquisition of the London Metals Exchange ("LME") in 2012 strengthens the working relationship between the LME and China, which represent the world's largest consumer of metals and world's largest exporter of base metals respectively.⁷²

Issuer Name	Issuer Domicile	Sector	Issuer Business Description	Capital Raised (US\$ billion)	Exchange
Glencore International Plc	Switzerland	Materials	Diversified Natural Resources Group	10.0	London, Hong Kong
Prada S.p.A.	Italy	Retail	Luxury Fashion Designer	2.5	Hong Kong
Shanghai Pharmaceuticals Holding Co. Ltd.	PRC	Health Care	Manufacturer of Pharmaceuticals	2.1	Hong Kong
Chow Tai Fook Jewelry Co. Ltd.	Hong Kong	Consumer Products	Manufacturer and Retailer of Diamond and Gold Jewelry	2.0	Hong Kong
New China Life Insurance Co. Ltd.	PRC	Financials	Life Insurance Company	1.9	Hong Kong, Shanghai
CITIC Securities	PRC	Financials	Provider of Investment Trust Management and Securities Brokerage Services	1.8	Hong Kong

⁷² "Hong Kong – Asia's Global Market, A Destination for International Listings", KPMG, September 2012, p 26.

<u>Issuer Name</u>	<u>Issuer Domicile</u>	<u>Sector</u>	<u>Issuer Business Description</u>	<u>Capital Raised (US\$ billion)</u>	<u>Exchange</u>
MGM China Holdings Ltd.	Macao	Media and Entertainment	Casino Gaming Resort Developers, Owners and Operators	1.6	Hong Kong
Hui Xian REIT	PRC	Real Estate	Real Estate Investment Trust	1.6	Hong Kong
Samsonite International SA	United States	Retail	Design, Marketing and Sale of Travel, Business and Casual Luggage	1.3	Hong Kong
Sun Art Retail Group Ltd.	PRC	Retail	Hypermarket Operator	1.2	Hong Kong

Figure 4-10: 2011 Top Hong Kong IPOs by capital raised⁷³

4.8.2 Proposal – focused development of key sectors

Natural Resources Sector: Efforts have been made by the regulators to boost Hong Kong’s profile as an IPO centre for mining companies, as evidenced by a chapter of the Listing Rules⁷⁴ (introduced in 2010) and ancillary guidance letters dedicated to the mining industry. HKEx executives have organised international conferences and engaged in other activities to promote Hong Kong as an international platform for natural resources companies seeking to list and raise funds in Asia.⁷⁵

There have been some rewards. In the year 2012 alone, six companies were accepted for listing on the HKEx with an industry classification of “metals and minerals”⁷⁶ and up to 16 October 2013, four additional companies were listed on the Main Board with a mining or natural resource-related business⁷⁷. Activity has slowed down somewhat in the

⁷³ “Global IPO Trends 2012”, Ernst & Young, p 7.

⁷⁴ Chapter 18 of the Listing Rules.

⁷⁵ See for example “the Exchange”, October 2009.

⁷⁶ HKEx Factbook 2012.

⁷⁷ 2013 New Listing Report, HKEx.

past two years, leaving our market some way from its goal of becoming a premium listing centre for the mining industry.

Experience shows that a country or territory without a large indigenous mining industry can successfully host the listings of premium mining companies, provided the talent and infrastructure are available. London is a good example of this.

Our Government should work closely with the industry to consider what can be done to enable Hong Kong to capture the next peak of the cycle. A key aspect of Hong Kong's capabilities in this area is the development of a supporting network of relevant industry professionals. For example, professional participants in our market with mining-related expertise are a minority and the "talent pool" is underdeveloped. Few professional geologists, mining consultants, research analysts in this field etc. are "home-grown". Where market regulators, investment institutions or other market stakeholders require their services, these professionals tend to be hired on an ad hoc basis and are often taken on from overseas.

Addressing these concerns calls for long term planning, potentially affecting many aspects of our society, including tertiary education, professional hiring policies, even immigration policies. However, given the importance of the financial markets to Hong Kong's economy as a whole, we trust that a timely re-consideration of our professional services infrastructure and what we can do to enhance our specialist capabilities will be beneficial to the overall development of the market.

Retail and Luxuries Sector: The growing affluence of the PRC population is conducive to the growth of fast retail and consumer good sectors of the Hong Kong market. Over the years, a large number of PRC retail companies have been successfully listed in Hong Kong. This is a track record that Hong Kong can use to attract international retailers. In addition, Hong Kong's traditional low-tax environment, its internationally recognised legal system and its established position as a premium centre for sale of international luxury goods give it an advantage in respect of the retail conglomerate and luxuries sector.

As outlined above, Hong Kong has suffered from some constraints due to the rigidity of our overseas companies listing regime and the limited

access to double tax arrangements. The Government should work closer with market professionals on what can be done to increase Hong Kong's "user-friendliness" for issuers engaged in the retail and luxuries sector.

In the meantime, the Government and regulators must also take a broad view of general global economic developments. They need to monitor emerging market trends closely to identify and capture opportunities in other business sectors.

4.9 CORPORATE GOVERNANCE INITIATIVE: DIVERSIFICATION OF LEGAL STRUCTURES

4.9.1 Issue

The HKEx Listing Rules are written primarily to cater to businesses organised in a common-law-type corporate structure. This can be seen in many practical applications, for example:

- The rules presume a capital structure consisting of shares, and returns to shareholders being made by way of dividends, distributions or return of capital, etc.
- The rules presume a distinction between the ownership and the management of the business in a classic corporate mode, with a governance or supervisory structure that consists of (or is akin to) a board of directors similar to that of a Hong Kong company.
- The rules presume a corporate mode of exercise of owners' rights, comprising the modes of receiving corporate information, attendance at members' meetings, voting at meetings in person or by proxy, etc.

As discussed in section 3.1 above, overseas companies organised along the lines of European, Japanese or other legal systems are often accepted for listing in Hong Kong, if the relevant procedures are followed. This does not mean, however, that businesses taking other legal forms – such as a US limited liability partnership or a Swiss Verein – may currently be listed in Hong Kong using the same procedures. With some limited exceptions, the rules of the Hong Kong market are made for corporations and only corporations may be listed here.

Listing Rules 2.03 and 8.11 further impose a “one share one vote” concept, often regarded as a cornerstone of shareholders’ protection under common law. Under Rule 8.11, for a class of securities to be listed, the voting powers attached to such securities must bear a reasonable relationship to the equity interest in such shares when fully paid. This predisposes the market against companies with weighted voting rights and other, more unusual, control and/or governance structures.

4.9.2 Proposal – diversification of holding and management structures

In today’s market, the HKEx’s orientation towards the corporate form may be unnecessarily restrictive. Whilst opening up the IPO market to other, potentially unfamiliar, forms of legal entities undoubtedly carries risks and will call for detailed analysis from different perspectives (including investors’ protection and enforcement), our regulators have over the past years tended to keep an open mind and are generally friendly towards innovation. With the benefit of public consultation and with appropriate safeguards, a gradual and orderly process of diversification of our IPO market into more alternative business forms may prove beneficial to the market as a whole.

In this regard, we are encouraged by the successful listings of a number of business trusts on the HKEx in recent years. We note that at this early stage, the legal structures of the listed entities in these cases are practically identical⁷⁸. Going forward, the regulators may consider giving more room for innovation.

In a similar vein, the “one share one vote” concept may be studied in more detail and re-considered with the benefit of public consultation. In the past, some overseas companies that may have had genuine commercial or legal reasons for having deferred capital (e.g. a legitimate desire to create public currency without diluting control) have avoided Hong Kong as a listing destination because of Listing Rule 8.11. While there may be good reasons for the rule to be upheld, we believe the Government and the regulators should keep reviewing some

⁷⁸To date, the market has seen three listed business trusts: HKT Trust, Langham Hospitality Investments and HK Electric Investments, all organised as single investment trusts. The listings were by way of joint issues of share stapled units by the trust and an associated corporate entity set up for the purpose. Each share stapled unit comprises a unit in the listed trust vehicle, a beneficial interest in a specifically identified share in the listed corporate vehicle, and a specifically identified preference share “stapled” to the unit.

of the fundamental underpinnings of the market, and to what extent modifications or partial relaxations may be appropriate. The regulators should continue to keep an open mind, which is crucial for ensuring our market is up to date.

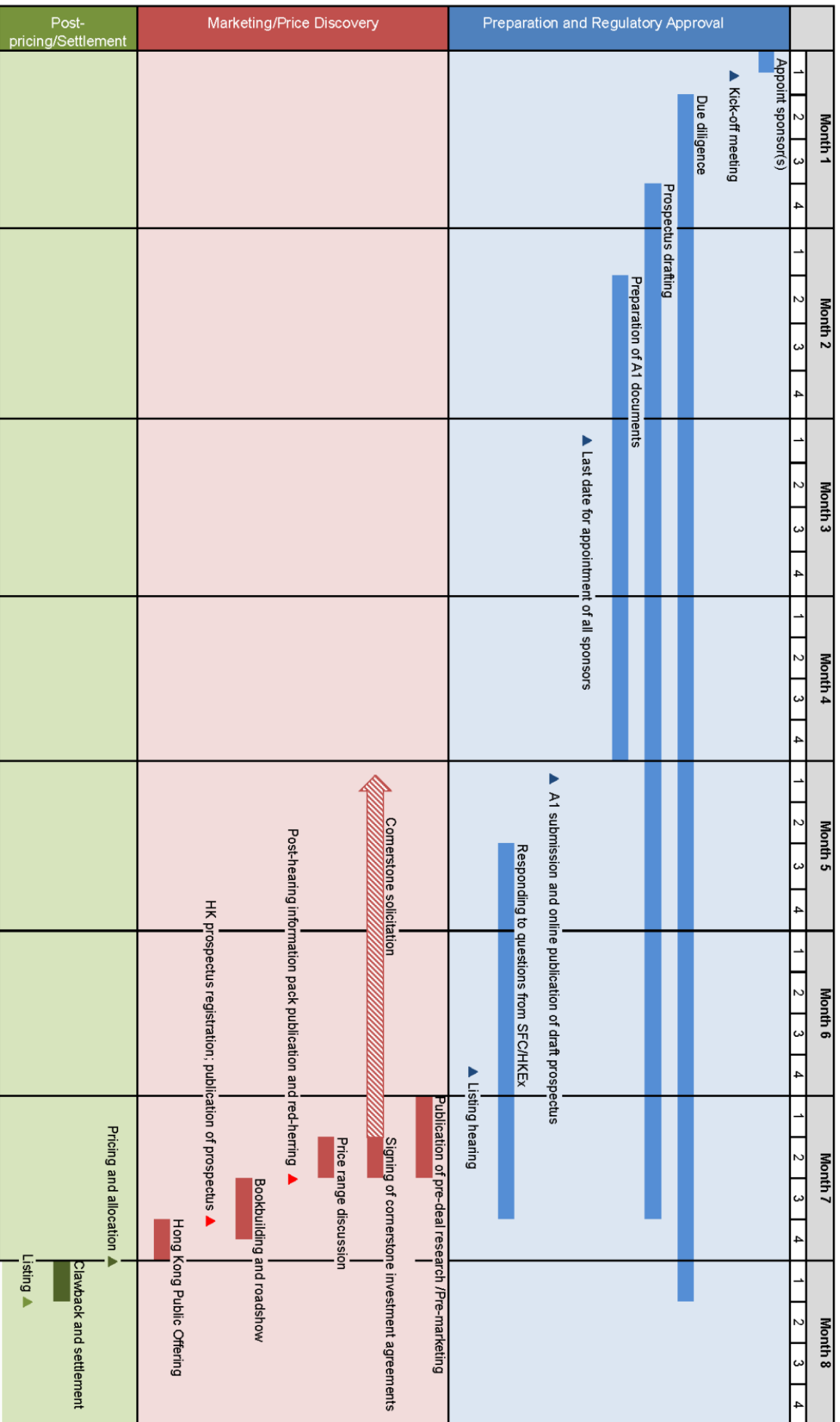
Section 5 CONCLUSION

Hong Kong continues to benefit from its position as China's gateway to the world (and the world's gateway to China). Over the years our progress has been considerable. This is, however, no cause for complacency, as competition among the global markets remains intense and Hong Kong is at risk of over-reliance on Mainland China as the source of its IPO candidates. Our IPO market must make every effort to diversify its "client base" and actively open up to quality companies from all corners of the world.

While the regulators have made significant and commendable efforts in many diverse respects, some of these efforts have not paid off as impressively as we would like to see. As we have examined in this paper, the market has been hampered by some important constraints in Hong Kong's infrastructure that are in need of review and, potentially, reform. While some of the issues can be alleviated by relatively light policy changes, others require longer term planning.

There have been little impetus in the past for an overall reconsideration of many aspects of our financial and legal infrastructure as well as market rules based on a "holistic" approach (i.e. with the philosophical underpinning that a system has properties that exceed the sum of its parts). Given the importance for Hong Kong to retain and consolidate its position as an international financial centre, we hope to provide, by this initial study, a catalyst for the Government and market regulators to engage in a comprehensive review of the issues highlighted in this paper, and to arrive at a suitable blueprint for the next stage of Hong Kong's development.

Appendix : The Hong Kong IPO Process - An Illustrative Timeline



About the Financial Services Development Council

The Hong Kong SAR Government announced in January 2013 the establishment of the Financial Services Development Council (FSDC) as a high-level and cross-sector platform to engage the industry and formulate proposals to promote the further development of Hong Kong's financial services industry and map out the strategic direction for development. The FSDC advises the Government on areas related to diversifying the financial services industry, enhancing Hong Kong's position and functions as an international financial centre of our country and in the region, and further consolidating our competitiveness through leveraging the Mainland to become more global.

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