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**Joint Consultation Paper: Proposed Enhancements to the Stock Exchange of Hong Kong Limited's  
Decision-making and Governance Structure for Listing Regulation**

**Response of Charltons Solicitors**

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We refer to the “*Joint Consultation Paper: Proposed Enhancements to the Stock Exchange of Hong Kong Limited’s Decision-making and Governance Structure for Listing Regulation*” published by the Exchange and the SFC (the **Consultation Paper**).

Unless otherwise specified, terms defined in the Consultation Paper have the same meanings in this response.

We welcome and appreciate the regulators’ continued efforts to keep Hong Kong’s regulatory regime under review in order to ensure that the quality and efficiency of the Hong Kong market is maintained and enhanced. There will be different views as to how those objectives are best achieved, but whatever the outcome, the market will undoubtedly benefit from the debate.

Whilst we agree that the Exchange and SFC should seek to ensure the quality of companies listed in Hong Kong and the efficiency of the listing application process, we do not believe that the Consultation Paper’s proposals (the **Proposals**) will improve either the quality of listed companies or the efficiency of the listing process and consider that these objectives can be achieved without the proposed changes to the current decision-making process and governance structure. We are particularly concerned that the Proposals would significantly increase the SFC’s powers to reject applicants for listing on the Exchange and to determine Exchange policy while removing the vital checks and balances on its exercise of its powers which are a fundamental part of the current regime. To increase the SFC’s powers in relation to listing applicants and listed issuers would be contrary both to the Exchange’s role as the front-line regulator and the SFC’s role as the independent statutory regulator of the Exchange. Further, we do not see how the Proposals would enhance and contribute to continuous market development in response to market demand.

We do not consider that the Consultation Paper has adequately established the need for the proposed major reforms. The current three-tier regulatory regime has been in place for some 20 years and has seen the market achieve considerable success. The Exchange has consistently ranked in the top five IPO fund-raising markets worldwide and was the world’s top IPO fund-raising market in 2015. This success has not been achieved at the expense of investor protection as demonstrated by Hong Kong’s first place ranking for minority investor protection by the World Bank in 2016.<sup>1</sup> The resilience of the existing regime is also evident in its withstanding of the financial crises of 1997 and 2008.

Set out below are our comments under headings suggested in the Consultation Paper.

#### **(a) Policy development**

It is our view that the Consultation Paper’s stated objectives in relation to policy development are already achievable under the current regime.

Those objectives include “*achiev[ing] closer coordination and cooperation between the SFC and the Exchange on policy formulation*”.<sup>2</sup> Under the current regime, SFC approval is a pre-

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<sup>1</sup> The World Bank’s report “*Doing Business 2016, Measuring Regulatory Quality and Efficiency*”.

<sup>2</sup> Paragraph 1(b) of the Consultation Paper.

condition for the following: (i) all amendments to the Listing Rules<sup>3</sup>; (ii) any Listing Rule waivers or modifications which will have general effect<sup>4</sup>; and (iii) all policy decisions which will have mandatory effect or be of general application.<sup>5</sup> Moreover, the SFC and the Exchange have entered into a [Memorandum of Understanding Governing Listing Matters](#) (the **MOU**) which provides for the Exchange to coordinate with the SFC in relation to policy. The Exchange's MOU obligations require it to inform the SFC of matters involving novel or potentially controversial or sensitive issues, or have public policy implications. The SFC and the Exchange already hold monthly Listing Matters Liaison Meetings at which policy issues and other matters are discussed.<sup>6</sup> The MOU also provides for meetings of a High-Level Group to review systemic and policy issues relating to listing matters.<sup>7</sup> The necessary provisions and forums for close cooperation between the SFC and Exchange on policy formation are therefore already in place and do not appear to require any change to the Exchange's governance structure.

A second stated objective in the Consultation Paper is that the SFC should be given "*earlier and more direct input on listing policy matters and listing regulation.*"<sup>8</sup> Under the current regime, the SFC is able to intervene to object to a listing application within 10 business days following its submission by virtue of its powers under the Securities and Futures (Stock Market) Listing Rules (the **Stock Market Listing Rules**). The SFC thus already has the ability to intervene in respect of a listing at the very beginning of the listing approval process. The SFC also receives listing applications under the dual filing process almost simultaneously with the Exchange, and long before the application is made available to the Listing Committee. There does not therefore seem to be any need to involve the SFC in the listing application process any earlier than it already is.

A particular concern with respect to policy making being vested in the proposed Listing Policy Committee is that its members do not have the front-line experience of the members of the Listing Committee. Moreover, the Listing Policy Committee's (the **LPC**) decisions will not be made public under the Proposals. There could then be a lack of transparency surrounding reform initiatives which are put to the LPC for approval but are rejected. Further, in order to remain competitive, the Exchange must innovate. None of the proposed members of the LPC would be an investment banker or corporate finance adviser with front-line experience of the market. This leads to a concern that the LPC may not initiate the type of innovative policies which the Exchange will require to keep pace with an ever-changing market.

#### **(b) Listing applications by new applicants**

It is proposed that decisions on listing applications involving LRC Matters would be made by the proposed Listing Regulatory Committee (the **LRC**) rather than the Listing Committee, which would only decide on applications not involving LRC Matters. Listing applications which involve

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<sup>3</sup> Section 24 of the Securities and Futures Ordinance.

<sup>4</sup> Listing Rule 2.04.

<sup>5</sup> Paragraph 6.4 of the Memorandum of Understanding Governing Listing Matters entered into between the SFC and the Exchange.

<sup>6</sup> Paragraph 10.3 of the MOU.

<sup>7</sup> Paragraph 5.1 of the MOU.

<sup>8</sup> Paragraph 1(a) of the Consultation Paper.

LRC Matters would, by definition, be the most difficult to decide. We consider that it is these difficult decisions that stand to benefit most from the considerable experience and expertise of the members of the Listing Committee. The Listing Committee's role in relation to these listings would however be reduced to commenting and those comments would be relayed to the LRC. In practice, we suspect that this proposal would be hampered by the fact that there is no forum for the members of the LRC to discuss the applications face-to-face with members of the Listing Committee. Furthermore, the LRC will be reliant on the Listing Committee's views being reliably relayed to its members. For these reasons, a number of parties have suggested that a better proposal would be for representatives of the SFC to attend meetings of the Listing Committee which will hear applications involving LRC Matters. As suggested by the response to the Consultation Paper of the Financial Services and Development Council, SFC representatives should attend Listing Committee meetings in the capacity of observers rather than committee members in order to prevent a conflict with the SFC's role as the independent regulator of the Exchange.

The key benefit of SFC representatives attending Listing Committee meetings is that it would provide a forum for matters to be discussed by representatives of all parties active in the Hong Kong IPO market: listed companies, investors, the regulators and market practitioners including lawyers, bankers, accountants and valuers. It would also offer the SFC representatives the opportunity to hear directly from listing applicants' directors and the sponsors who often attend Listing Committee hearings at the committee's invitation.

A major concern in relation to the Proposals relating to listing applications is that the Listing Committee's role will be substantially reduced. While it will still comment on applications involving LRC Matters, there is no guarantee that its comments will be reflected in the decisions of the LRC. Nor is there any obligation on the Listing Committee's members of the LRC to vote in accordance with the views of the Listing Committee. Thus the Listing Committee would only have real decision-making power in relation to the most straight-forward listing applications. The Proposals could further negatively impact the Listing Committee since membership of the Listing Committee may prove to be of far less interest to experienced market practitioners than is currently the case.

We are also concerned that the Proposals will increase the SFC's control over which companies are admitted for listing and permitted to remain listed. The SFC's role as envisaged under the statutory framework (i.e. the Securities and Futures Ordinance (the **SFO**) and the Stock Market Listing Rules) is that the SFC acts as the independent regulator of the Exchange. Its powers under the Stock Market Listing Rules to object to listing applications on certain grounds and within specified time periods were intended to be reserve powers. The Proposals however would see the SFC moving to the role of front-line regulator in the case of the most difficult and important listing applications. This not only diminishes the role of the Exchange as front-line decision-maker, but also blurs the line between the role of the SFC as decision maker on Exchange listing applications and regulator of the Exchange. As has been pointed out by other parties, we consider that the proposal that SFC executives should be involved in the making of listing decisions raises fundamental conflict issues given the SFC's supervisory role under the SFO.

We also doubt that the Proposals will improve the efficiency of the listing process particularly for those applications involving LRC Matters which are likely to take longer since they would be subject to review by two committees rather than one. This inefficiency could also be exacerbated by the fact that after the Listing Committee meeting to consider the application, its comments would then need to be relayed by the Listing Department to members of the LRC, as well as to the listing applicant and its sponsor. We also have doubts as to whether the Proposals will combat abusive practices, such as shell company and backdoor listings. If these practices are a primary reason behind the Proposals, we would suggest that the regulators should refocus instead on increasing robust enforcement of the existing rules on cash companies, de-listings of long-suspended companies and reverse takeovers to clamp down on shell listings as well as enforcement of the laws on market misconduct to deal with pricing manipulation which is potentially damaging to the market's reputation.

Listing applications would no longer be reviewed by the SFC as they are currently under the dual filing process. Applications not involving LRC Matters should then be approved more quickly than at present. There is however a risk that in designating listing applications as not involving LRC Matters, when presented to the Listing Committee for decision, they will come with the presumption that they are "routine". They could however involve other issues, such as specific industry-related issues, which the Listing Department may not pick up on, but which require serious scrutiny. There is then a risk that the streamlining of listing procedures will result in problems being missed in more cases than under the current arrangements where applications are subjected to the dual scrutiny of the SFC and the Exchange. It would in any event be open to the SFC under the current regime to increase efficiency by choosing not to comment on all listing applications. Based on the Proposals, this is a position which the SFC would apparently be willing to adopt.

As to the need to improve the efficiency of Hong Kong's listing approval process, it should be noted that this has become more efficient since the implementation of the significant changes to the listing application procedure in October 2013. The requirement for submission of substantially complete Application Proofs at the time of applying to list and the Exchange's primary focus on substantive issues resulted in the percentage of listing applications reviewed by the Listing Committee within 120 days after submission increasing to 72% in 2014<sup>9</sup> from just 33% in 2012.<sup>10</sup> Market participants surveyed by the SFC for its Reports on the Securities and Futures Commission's Annual Review of the Exchange's Performance in its Regulation of Listing Matters consistently express their general satisfaction with the Exchange's efficiency and fairness in vetting listings.<sup>11</sup> Whilst improved efficiency is desirable, it would not therefore appear that the market perceives a pressing need to improve the efficiency of Hong Kong's listing procedures.

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<sup>9</sup> SFC. *Report on the Securities and Futures Commission's 2015 annual review of the Exchange's performance in its regulation on listing matters*. June 2016. Paragraph 30.

<sup>10</sup> SFC. *Report on the Securities and Futures Commission's 2013 annual review of the Exchange's performance in its regulation of listing matters*. December 2013. Paragraph 33.

<sup>11</sup> *Ibid.* at Appendix A.

## Dangers of Trying to Identify Potential Shells at the Listing Application Stage

Comments in the media have suggested that one of the main reasons for the proposed regime reforms is that the SFC wants to reduce the number of shell listings and reverse takeovers on the Exchange which have attracted negative publicity. While we understand these concerns, we consider that the Proposals' approach risks damaging the competitiveness of the Exchange as a listing venue since the increasingly arduous and expensive listing application process has the potential to reduce the attractiveness of a Hong Kong listing.

As already mentioned, increased surveillance and more robust regulation of listed companies could do much to discourage shell and backdoor listings. The regulation of reverse takeovers has been tightened by the Listing Committee in the last few years. Measures adopted have included: tightening the regulation of reverse takeovers under Guidance Letter 78-2014; a new requirement for issuers to demonstrate remaining businesses' viability and sustainability after disposals of significant assets (or distributions in specie); and the application of the cash company rules to substantial cash injections into listed issuers. These matters are reviewed by the Listing Committee and reported on in its annual reports. We would recommend increased monitoring of listed companies' acquisitions and disposals to identify reverse takeovers and ensure application of the reverse takeover rules which require the production of a disclosure document substantially similar to an IPO prospectus where a transaction seeks to circumvent the requirements for a new listing.

The remaining concerns surrounding shell companies are arguably best dealt with by a more efficient delisting process to remove shell companies from the market. This would appear to be a better solution than subjecting all listing applicants, or at least all SME listing applicants, to the highly subjective process of trying to determine whether they are prospective shells at the listing application stage. Given the extremely broad criteria for determining shells<sup>12</sup>, it is virtually impossible to ensure that in attempting to weed out those intending to profit from a status as a listed shell, genuine listing applicants are not rejected or subjected to delays in the process. The Exchange's recent guidance on shell listings<sup>13</sup>, for example, has the potential to operate harshly in relation to genuine SME listing applicants and risks discouraging the listing of SMEs in genuine need of investment.

### **(c) Matters involving listed issuers**

Our concerns in relation to how LRC Matters involving listed issuers would be dealt with under the Proposals are essentially the same as for the Proposals relating to listing applications involving LRC Matters.

We would again stress the vital role played by the market practitioner members of the Listing Committee. The role of practitioner-based regulation in Hong Kong has its origins in The Hay Davison Report whose view was Hong Kong should adopt a practitioner-based regulatory system to *"avoid the danger of straight-jacketing the securities market by a strict regulatory*

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<sup>12</sup> HKEX. "Guidance Letter HKEX-GL68-13A". June 2016.

<sup>13</sup> Ibid.

*regime which might all too easily lead to insensitive or heavy handed over-regulation*".<sup>14</sup> We would agree with its views that "market management and regulation by practitioners offers scope for flexibility and adaptability in a rapidly changing market" and that "statutory regulators will not always have the necessary knowledge and expertise".<sup>15</sup>

**(d) Reviews of listing decisions**

Under the Proposals, decisions of the LRC to reject listing applications would be entitled to a review by the proposed Listing Regulatory Review Committee (**LRRC**) made up of the Chairperson and CEO of the SFC, an SFC non-executive director, and three former Listing Committee members nominated by the Listing Nominating Committee.

Our concern in relation to this proposal is that an aggrieved listing applicant will not be entitled to have the decision of the LRC reviewed by the Securities and Futures Appeal Tribunal (the **SFAT**), but only by the LRRC whose membership structure, like that of the other new committees, would give the SFC representative members a right of veto over decisions on any matters coming before the committee. Under the current regime, the SFC's right to object to a listing application pursuant to its powers under the Stock Market Listing Rules, is subject to the listing applicant's right to a review of the SFC's decision by the SFAT.<sup>16</sup> It could be argued, that where the SFC representative members of the LRC effectively block a listing application by voting against it, the SFC is effectively exercising its right under the Stock Market Listing Rules to object to the listing application, albeit arguably outside the period specified in those rules for the right of objection to be exercised. On that basis, it could be argued that the decision of the LRC should be subject to review by the SFAT. However, under the Proposals, the SFC would effectively be able to side step exercising its powers under the Stock Market Listing Rules to object to a listing application since it would be able to achieve the same result through its members of the LRC voting against approving the listing.

This would however seem to be manifestly unfair. The SFAT is chaired by a judge and its statutory purpose is as a statutory safeguard to ensure that regulatory decisions made by the SFC are reasonable and fair. It thus serves the purpose of enhancing the SFC's accountability.<sup>17</sup> A listing applicant who is dissatisfied with an SFAT decision has a further right of appeal on a point of law to the Court of Appeal.<sup>18</sup> It is worth noting that listing applications which do not involve LRC Matters and would continue to be decided by the Listing Committee would still have a right to appeal a decision of the SFC to object to their listing to the SFAT. This will be the case as the SFC's only right to influence non-LRC Matter listing applications will be through exercise of its Stock Market Listing Rules powers. Incongruously therefore, those applications which are most likely to be rejected by the LRC and involve an aggrieved listing applicant, would be those with least right to review by an independent body.

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<sup>14</sup> Hay Davison Report. May 1988.

<sup>15</sup> Ibid.

<sup>16</sup> Section 217 of the SFO.

<sup>17</sup> Homepage of the Securities and Futures Appeals Tribunal at <http://www.sfat.gov.hk/english/aboutus/welcome/>.

<sup>18</sup> Section 229 of the SFO.

The right to have a decision of the SFC reviewed by the independent SFAT operates as a vital check and balance on the SFC's exercise of its statutory powers. The problem with the Proposals is that they would essentially provide the SFC with a means of bypassing the statutory process for objecting to a listing application and with it the listing applicant's right to have that decision reviewed by the SFAT.

A further concern which the Consultation Paper does not address is how the LRRC would be able to act as the review body for decisions of the LRC given that the LRRC would be composed as to 50% of its members of senior SFC officials. The body whose decision the LRRC would review would have a similar composition. There is however a question as to whether the LRRC's SFC members would be obliged to ratify the decisions of the LRC's SFC members, or whether the latter decisions could be overturned.

#### **(i) Composition and Procedures of the Listing Policy Committee**

##### Composition

The Consultation Paper presents the new committees as under the joint control of the Exchange and the SFC. In reality however, the SFC's control over appointees to the Listing Committee would mean that it would effectively control the composition of both new committees.

The SFC would directly control the composition of half the members of the LPC, the CEO of the SFC, two SFC senior executives and the Takeovers Panel Chairman, who is appointed by the SFC under section 8(3) of the SFO, despite the Takeovers Panel having the right to elect its Chairman under section 8(6) SFO, where the SFC has not appointed the Chairman. The LPC's other four members would comprise the HKEX's Chief Executive, and the Listing Committee's Chairman and two Deputy Chairmen. In fact however, the SFC can veto the nomination of any person for appointment to the Listing Committee by virtue of the fact that the Listing Nominating Committee is made up as to 50% of SFC representatives.

##### Procedures

It is proposed that majority approval is required for decisions of the LPC. This may not however be achievable in the event of a tied vote since the Chairman would not have a casting vote, notwithstanding that this is also contrary to the Articles of Association of the Exchange and HKEX.

#### **(j) Composition and Procedures of the Listing Regulatory Committee**

##### Composition

Three of members of the LRC would be SFC senior executives and three would be the Listing Committee's Chairman and two Deputy Chairmen nominated by the Listing Nominating Committee (**LNC**), itself composed of equal numbers of HKEX and SFC representatives. The absence of a casting vote on the Listing Nominating Committee means that the SFC has an effective veto over the appointment of any individual appointment to the Listing Committee



and, thus can effectively block a person from appointment to the LRC. The Exchange and the Listing Committee have no comparable influence over the SFC representative members of the LRC.

#### Procedures

As mentioned above in relation to the LPC, the absence of a Chairman's casting vote means that it is unclear what would happen if there is a tied vote. On a decision relating to suitability, for example, it is not clear whether a tied vote would mean the listing application fails or goes ahead. Likewise for decisions relating to listed issuers, for example in relation to an alleged breach of Listing Rule 13.24 for insufficient operations, would a tied vote mean that the issuer remains listed or is suspended?

#### **(j) Composition and Procedures of the Listing Regulatory (Review) Committee**

Our comments in relation to the LRC and LPC above in relation to the lack of a Chairman's casting vote apply equally to the LRRC.

#### **(k) Composition and Procedures of the Listing (Disciplinary) Committee, the Listing (Disciplinary Review) Committee**

Please see comments above regarding the lack of a Chairman's casting vote which is a requirement under the Articles of the Exchange and HKEX.

#### **(l) Other Matters**

Other concerns in relation to the Proposals are set out below.

##### **(i) Legislative authority for proposed SFC role**

The Consultation Paper does not set out how the proposed arrangements fit into the current regulatory structure created by the SFO and the Stock Market Listing Rules.

According to the Consultation Paper, in determining listing applications involving LRC Matters, the SFC representatives on the LRC would "*in effect be able to exercise [the SFC's] power under [section 6 of] the Stock Market Listing Rules*".<sup>19</sup> The right of the SFC to object to a listing application under the Stock Market Listing Rules can be exercised during the 10 business days after the submission of a listing application or the 10 business days following the listing applicant's provision of any further information requested by the SFC within the 10 business days after submission of the listing application or receipt of any such further information requested by the SFC.<sup>20</sup> The Proposals however would allow the SFC, through its representative members of the LRC, to object to listing applications at LRC meetings held *at any time* (i.e. outside the time periods specified in the Stock Market Listing Rules). It is arguable that this would only be allowed under the Stock Market Listing Rules if the SFC, for each listing application involving LRC Matters, were to make repeated requests for

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<sup>19</sup> Paragraph 18 of the Consultation.

<sup>20</sup> Rules 6(2) and 6(6) of the Stock Market Listing Rules.

further information to extend its right to object to a listing application beyond the 10 business days after its submission. This is clearly not what is intended by the Proposals and would probably be unworkable once reasonable requests for further information can no longer be justified. It is thus arguable that amendments to Rule 6(2) of the Stock Market Listing Rules are required to facilitate the exercise of the SFC's powers as envisaged by the Proposals.

It is also questionable whether the SFC, as the Exchange's independent regulator, can be represented through its staff on committees of the Exchange without legislative amendment. The proposal that SFC representatives should participate as members of committees of the Exchange would appear to merge the roles of the SFC (as statutory supervisor) and the Exchange (as supervisee) contrary to the legislative intent of the SFO.

We note that the matter of the Exchange's perceived conflict as a profit making company has been noted by certain parties. In our view this conflict is more perceived than real since the majority of the Exchange powers have been delegated to the independent Listing Committee. This delegation occurred to "manage potential conflicts of interest and ensure the independence of the listing function".<sup>21</sup> Further, of the Listing Committee's 28 members, only one is a representative of the Exchange, the Chief Executive of the HKEX.

#### **(ii) Enhancing the role of the Exchange as an international market**

The SFC's statutory role in relation to the Hong Kong IPO market is "*to supervise, monitor and regulate ... the activities*"<sup>22</sup> of the Exchange. It also plays a key role in investor protection.<sup>23</sup> The SFC's role in "*maintaining the status of Hong Kong as a competitive international financial centre*" is confined to a requirement that it should have regard to the desirability of this in performing its functions<sup>24</sup>.

It needs to be considered whether the SFC's role as regulator of the Exchange and protector of investors' interests is compatible with the need to enhance the Hong Kong securities market to ensure that it remains competitive in relation to other international stock markets. While the SFC has a legitimate role in preventing problems and protecting investors' interests, we are concerned that this role could lead the LPC and LRC to be excessively risk-averse in policy formulation and decision-making, which could stifle market development and undermine the Exchange's competitiveness. The SFC's refusal to support a public consultation on the Exchange's draft proposal on weighted voting rights structures despite market support for a second stage consultation<sup>25</sup> could be seen to be an example of the SFC's role as protector of investor interests inhibiting market development.

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<sup>21</sup> At paragraph 40 of the Consultation Paper.

<sup>22</sup> Section 5(1)(b)(i) of the SFO.

<sup>23</sup> Section 5(1)(l) of the SFO.

<sup>24</sup> Section 6(2)(a) of the SFO.

<sup>25</sup> HKEX. "*Consultation Conclusions to Concept Paper on Weighted Voting Rights*". June 2015. Chapter 5.

We would argue therefore that the current Listing Committee, with its broad range of expertise and front-line knowledge of market demands and direction, is better placed to set policy in consultation with, and subject to the SFC's final approval.

In conclusion, we consider that the regulators should reconsider the proposed reforms and focus instead on seeking to discourage practices such as shell listings and pricing manipulation through the allocation of enhanced resources for active surveillance and monitoring of listed issuers' activities and parties engaged in suspected price rigging of "shell companies" and reverse takeovers. Concentrating efforts on post-listing enforcement and delisting long-suspended companies would in our view do more to improve the quality of the Hong Kong market than the Proposals which risk making the listing application process more complicated and expensive than is already the case. This must be avoided if the competitiveness of the Exchange as an international fund raising platform is to be maintained and enhanced.

Finally, we consider it vital that the SFC's role is that of independent regulator of the Exchange. Primary responsibility for approving listing applications and cancellations of listing, as well as listing policy and market development properly lies with the Exchange. The SFC, on the other hand, rather than seeking to assume a role on the front-line of decision-making and policy setting, plays a more valuable role as regulator of the Exchange and protector of investors' interests. We consider it essential that the SFC retains its independence of the Exchange so that there is no blurring of the lines between the Exchange as decision maker and the SFC as regulator. Furthermore the exercise of the SFC's powers must remain subject to judicial review and review by the Securities and Futures Appeal Tribunal to ensure the checks and balances which are a fundamental part of the Hong Kong market.