Submission to the
Expert Group to Review the Operation of the Securities and Futures Market Regulatory Structure

by

David M. Webb

Editor, Webb-site.com
Member, SFC Shareholders Group
Member, Takeovers and Mergers Panel
Member, Shareholders Sub-Committee of the Standing Committee on Company Law Reform

25th November, 2002

CONTENTS

1. How to Read this Document

This document is best read online. Underlined text includes hyperlinks, and if you click on the text, you will go directly to referenced documents on the internet. The full links are also given as footnotes, in case you are reading a printed copy of this document and wish to type them in.

This document starts with a recitation of Facts (Section 2), then follows with Observations (Section 3) and Conclusions and Recommendations (Section 4).

2. The Facts

2.1 HKEx is for profit

Hong Kong Exchanges and Clearing Limited[1] ("HKEx") and its subsidiaries are for-profit companies. Their directors have a fiduciary duty to maximise value for their shareholders. To incentivise this, the CEO and certain executive staff down to Senior Manager grade (143 in total at the time of the Listing of HKEx) receive share options. There are other profit-related incentives such as salary increases, "performance-related bonus" or (more basically) job retention.

2.2 SEHK and the making of Listing Rules

The Stock Exchange of Hong Kong Limited ("SEHK") is a wholly-owned subsidiary of HKEx. SEHK has a legally protected monopoly to "establish, operate and maintain a stock market in Hong Kong" under s27, Stock Exchanges Unification Ordinance[2] ("SEUO", Cap. 361).

Under s34 of SEUO, SEHK makes the Listing Rules[3], including the GEM Listing Rules[4].

Under s35 of SEUO, SFC can only approve or reject changes to the Listing Rules proposed by SEHK. The SFC cannot direct that changes be made.

There is a is a reserve power under s14 of the Securities Ordinance[5] ("SO", Cap. 333) for the SFC to superimpose its own listing rules, but the SEHK's Listing Rules would continue in effect as long as they are not "*repugnant to any rule made by the [SFC]*".

The SFC and SEHK signed an MoU Governing Listing Matters[6] in 1991 ("MoU" updated 6-Mar-00 to reflect the creation of HKEx). Under this MoU, the SFC reserved the right to exercise its powers under s14 of SO if the SEHK failed to comply with the MoU. The implication is that otherwise, these powers will not be exercised, and so far they never have. To do so would be politically explosive and the MoU would be dead.

Under the MoU, the Board of SEHK delegated all its powers on listing matters to the Listing Committee ("LC"). The Rules Governing the Proceedings of the LC are appended to the MoU. This delegation in effect means that the LC has the final say on when and what rules changes are proposed to the SFC for approval.

---

[1] http://www.hkex.com.hk
[2] http://www.justice.gov.hk/blis.nsf/CurAllEngDoc?OpenView&Start=361.1.1&Count=52
[3] http://www.hkex.com.hk/rulereg/listrules/listrules.htm
[4] http://www.hkgem.com/listingrules/rules/e_main.htm
[5] http://www.justice.gov.hk/blis.nsf/CurAllEngDoc?OpenView&Start=333.1.1&Count=256
[6] http://www.hkex.com.hk/rulereg/mou/p001.pdf

2.3 The Listing Committee

The current composition of the main board LC is determined by Listing Rules 2A.17-2A.26. Other than the CEO of HKEx, there are 24 part-time outsiders. Under those rules, six are exchange participants (i.e. brokers), six are directors of listed issuers (and cannot be employees of brokers), and the remaining 12 are drawn from 5 categories, including accountants, lawyers, merchant bankers, fund managers and others.

In fact, according to Annex 4.9[7] of the Report of the Panel of Inquiry on the Penny Stocks Incident[8] ("PIPSI Report"), only one of the members is a fund manager.

The GEM LC comprises 21 members, of which 20 are outsiders, and again, a maximum of 4 may be fund managers.

On 24-Jul-02 the Secretary for Financial Services and the Treasury ("SFST"), SFC and HKEx announced[9] that a new merged LC would start operation from 1-Jan-03. The names of the Chairman and two vice-Chairmen were announced, none of whom represents a fund manager. The committee will consist of "24-30" members. No further details have been announced. The proposal would require amendments to the main board and GEM Listing Rules. For more comments on the proposed revised listing regime, see Listing Chaos[10] (*Webb-site.com*, 28-Jul-02).

2.4 Administering the Listing Rules

The Listing Rules are contractual and non-statutory. The SEHK cannot fine offenders for breaching the rules. The sanctions (one cannot use the word "penalty") include private or public statements by SEHK criticising, censuring, or stating that a directorship is prejudicial to the interests of investors, or a suspension or cancellation of the listing. The latter two penalties obviously affect minority shareholders more than the offending parties, and to my knowledge a company has never been delisted simply because its directors caused it to break the rules. Other sanctions include a possible "Cold Shoulder" order that prohibits dealers and financial advisers from acting for an issuer. To my knowledge, that sanction has never been used by SEHK.

2.5 Vetting of announcements and circulars

As the Listing Rules are non-statutory, before clearing announcements, the SEHK can ask questions, but it has no powers of investigation. The SFC on 6-May-02 announced[11] a proposed "dual filing" system which means that all announcements and circulars would be filed with the SFC, giving them a right of action for false and misleading disclosure. However, this is after-the-fact enforcement rather than pre-emptive action before release.

2.6 HKSCC

HKEx also owns Hong Kong Securities Clearing Company Limited ("HKSCC"), the *de facto* monopoly clearing company. It runs the Central Clearing and Automated Settlement System ("CCASS"), an immobilized book-entry system.

---

[7] http://www.info.gov.hk/info/pennystock/annex4.9.pdf
[8] http://www.info.gov.hk/info/pennystock-e.htm
[9] http://www.info.gov.hk/gia/general/200207/24/0724130.htm
[10] http://webb-site.com/articles/listingchaos.htm
[11] http://www.hksfc.org.hk/eng/press_releases/html/press_release/02/02pr72.htm

2.7 SEHK revenue and profit

On each side of a trade, SEHK collects 0.005% transaction fee and HKSCC collects 0.002% settlement fee. Ranked by size, the top decile (10%) of listed companies account for about 90% of total market capitalization and generate a corresponding proportion of the transaction fees.

Similarly, listing fees are based on either the market cap (at initial listing) or the par value of outstanding issued shares (for annual fees).

The cost of administering the Listing Rules is about the same for a $100bn company as a $100m company. So for around a 1,000-fold difference in SEHK transaction revenue and an 8-fold difference in listing fees, the regulatory cost base is roughly the same. Indeed, some of the smaller companies have arrived at that size due to financial difficulties, which tends to increase the amount of regulatory oversight due to vetting of restructuring documents including connected transactions, rights issues and so on.

Hence, large listed companies account for most of the profits of SEHK, and the smallest and troubled ones probably contribute losses. I cannot quantify these because private companies in HK, including subsidiaries of HKEx, are not required to file financial statements with the Companies Registrar, and the group accounts do not provide sufficient detail. The Expert Group should be able to obtain audited subsidiary accounts from HKEx.

2.8 SFC

Under s5 of the Securities and Futures Commission Ordinance ("SFCO", Cap. 24), the Chief Executive of Hong Kong ("CEHK") appoints and may remove the Chairman and the other directors of the SFC, of which half are executive (including the Chairman) and half are non-executive, with a minimum of 8 directors in total. Under s11 of SFCO, The CEHK can also direct the SFC as regards the performance of any of its functions. As such directions are not required to be published, the public may not know when and how such power is being used.

2.9 The Codes

The Corporate Finance Division of the SFC ("CFDSFC") administers the Codes on Takeovers and Mergers and Share Repurchases (the "Codes"). The Codes are non-statutory so do not have the force of law. Amendments to the Codes are made by the SFC after consultation with the Panel. In practice, this is usually preceded by a market consultation.

The Executive Director of CFDSFC ("Executive") may institute disciplinary proceedings before the Takeovers and Mergers Panel ("Panel") when it considers that there has been a breach of either the Codes or of a ruling of the Executive or the Panel.

Similar to SEHK's sanctions under the Listing Rules, the sanctions available to the Panel include private or public statements criticising or censuring the offender, or a "Cold Shoulder" order requiring dealers and advisers not to act for the offender for a stated period. The Panel can also require further action as it "thinks fit" although, as the Codes are non-statutory and hence unenforceable, this sanction is usually given as an alternative to the Cold Shoulder – for example, requiring an offender to make a general offer, failing which a Cold Shoulder order is imposed against him.

2.10 Other powers of the SFC

The SFC has powers under s45 and s37A of the SFCO (in the latter case after consultation with the Financial Secretary) to intervene to defend minority interests, seeking either a winding up (s45) or an alternative remedy (s37A) in cases of unfair prejudice, but it has not used these powers since the case involving Mandarin Resources which began in 1996.

2.11 Financial Secretary

A fourth element in the regulatory system is the Financial Secretary, who has the power to seek a winding up under s147 of the Companies Ordinance[12] ("CO", Cap.32) or an alternative remedy under s168A of CO based on an Inspector's Report under that Ordinance.

So far as I am aware, there has been no use of these powers in recent years.

As a matter of law, the SFC has to consult with the Financial Secretary in a number of its activities, such as the use of s37A of SFCO. Other matters, such as inquiries by the Insider Dealing Tribunal, are at the discretion of the Financial Secretary "*whether following representations by the [SFC] or otherwise*" - see Section 16 of the Securities (Insider Dealing) Ordinance[13] ("SIDO", Cap.395).

2.12 The SFC Shareholders Group

On 28-May-01, the SFC announced the formation of a new Shareholders Group ("SG") *"to provide advice and feedback to the SFC on issues relating to shareholders rights and interests"*. I have been a member of that group since its formation.

On 12-Jun-02, the SFC announced that it had reconstituted and formalized the SG as a standing committee under section 6 of the SFCO. This followed observations from myself and other members that the original composition was more of a "cross-industry" group than a shareholders group, and that to provide more effective feedback on shareholder interests, it should be composed principally of those with shareholder interests. The SG, as currently constituted, is the first and only entity set up under Government auspices which reflects investor interests.

The PIPSI Report in paragraphs 7.71 to 7.76 describes a clash of views between HKEx and SFC about the role of the SG in relation to the preparation of the Jan-02 consultation paper on the Listing Rules relating to corporate governance. The HKEx wrote to SFC on 12-Dec-01:

> "As for the views of the [SG], we consider it is only appropriate that they be considered in the market consultation process at the appropriate time…
>
> …please confirm that in future draft policy papers provided by us to the SFC in confidence will not be passed to the [SG] for discussion unless prior agreement has been given by us."

while the SFC replied on 14-Dec-01:

> "Given the importance of the issues that the draft proposals address and the key advisory role of the [SG], I am convinced that had we not consulted the [SG] at this stage we would have been subject to justifiable criticism,

[12] http://www.justice.gov.hk/blis.nsf/CurAllEngDoc?OpenView&Start=32.1.1&Count=640
[13] http://www.justice.gov.hk/blis.nsf/CurAllEngDoc?OpenView&Start=395.1.1&Count=48

including by members of the [SG]. Exercises like this are what the [SG] is for."

In his submission to PIPSI, the HKEx CEO reversed the HKEx's position, stating:

> "In so far as the [SG] is concerned, the Exchange accepts that the [SG] is part of the consultation structure under the SFC and believes that the SFC would have raised with the Exchange any serious comments from the [SG] …during the course of preparation and discussion of the draft Consultation Paper."

In other words, "in future, you can show the SG the drafts". PIPSI commented:

> "We hope that the current direction can be maintained. If Mr Kwong's current understanding had earlier been communicated to the SFC, instead of the strongly worded version, the SFC would have been able to consult its [SG] fully on the HKEx's consultation papers…"

Recommendation 14.8 of the PIPSI Report reads in part:

> "The SFC should feel able to consult its Shareholders Group…on draft consultation papers sent to it for comment by the HKEx."

2.13 The preparation of the revised Consultation Paper on delisting criteria

[Due to the secrecy obligations imposed on members of the Shareholders Group by s59 of the SFCO, I must exclude this section 2.13 from this published version of the submission and have made this a separate, private submission to the Expert Group, which the SFC has advised falls within the exception to s59].

---

3. Observations

In this Section 3, I will make observations and comments on the implications of the facts outlined in the previous section. Conclusions and recommendations follow in Section 4.

3.1 HKEx conflict of interests 1: for-profit v for-regulation

There is probably no other sector in the economy where a front-line regulator is also a for-profit company. We may float the airport company, but we would never float the Civil Aviation Department which regulates aviation. Similarly, we have listed telephone companies, but we do not float their regulator, OFTA.

In the UK, when the London Stock Exchange ("LSE") was demutualised, the Listing Authority[14] was transferred to the Financial Services Authority, and the Listing Rules were given statutory backing. The LSE is now in the business of providing efficient trading and pricing to its users, and not in the "business of regulation" – a term which is an oxymoron.

The key point here is that, in the short to medium term, the less that HKEx spends on regulation, the more profit it makes for its shareholders. The more companies it lists, the more profit it generates (particularly for large ones). If it suspends a company from trading, it loses transaction revenue.

While HKEx claims a "Chinese Wall" between the Listing Division and the rest of the business of HKEx, there is no escaping the fact that the staff and other resources are paid for from a group budget funded by group revenues, and its expenses are part of the group income statement. In short, there is a direct and inescapable conflict of interest between being a regulator and a for-profit company.

HKEx argues that it has a statutory duty to put the "public interest" ahead of all other interests, under s8 of the Exchanges and Clearing Houses (Merger) Ordinance ("ECHMO", Cap. 555). However, a breach of that duty would be almost impossible to prove, as would the claim for damages, so it is practically meaningless. You cannot legislate your way out of a conflict of interest.

HKEx also claims that it has the long term interest of a higher quality market, so that trading volumes and market cap will increase. However, I believe the short term incentives far outweigh the longer term. The current management of HKEx is unlikely to be running it in 10 years time.

HKEx claims that it is closer to the market than the SFC and therefore better placed to be a regulator. That is nonsense. If proof was needed, the Penny Stocks Incident showed that HKEx was unable internally to predict the logical investor response to its proposals. The SFC regulates brokers and asset managers, investigates insider dealing and market manipulation, and implements the Takeover Code. It cannot be said to be distant from the market.

The reality of the priorities of HKEx is perfectly illustrated by its behaviour in the following GEM case study.

[14] http://www.fsa.gov.uk/ukla/

3.2 The GEM case study

When GEM was launched in Nov-99, at the height of the dot-com boom, the SEHK almost immediately began granting waivers of its own listing rules. It claimed that these waivers were not given to favour particular issuers but were available to all who asked. For a detailed discussion of this, see "Waivers Galore for Tom.com[15]" (*Webb-site.com*, 21-Feb-00).

At the time, the Chairman of the GEM LC stated a goal of 100 listed companies and HK$100bn of market capitalization, despite the fact that GEM was originally designed for Small and Medium Enterprises ("SMEs") who could not meet main-board entry criteria.

I was a member of SEHK's New Markets Development Group which designed the GEM framework, and we took care to balance the need for SMEs to access public equity versus the desire to deter "quick buck" schemes. Accordingly, we included, *inter alia*, a requirement for a 2-year track record and a 2-year management shareholder lock-up after IPO. These rules were either directly waived or in some cases ignored in opening the GEM to a range of spin-offs from HK's tycoon-controlled conglomerates, none of which conglomerates could be called an SME, but all of whom cashed in on very cheap bubble capital. The reduced track record and lock-up also attracted a number of smaller issuers which were little more than scams driven by financial engineering.

In short, by bending the rules, there was a trade-off of quality for quantity.

Eventually, the waivers became so embarrassing that questions were asked in the Legislative Council ("LegCo"), and the SFC and SEHK hammered out a standstill announced on 11-Mar-00 with a set of compromises which would then be subject to market consultation. SEHK agreed to stop waiving its rules in a wholesale fashion (which was against the rules anyway). See GEM Waivers Reviewed[16], (*Webb-site.com*, 12-Mar-00).

A consultation paper was published on 23-May-00 and the submission period ended on 30-Jun-00. It then took fully 13 months before SEHK and SFC could reach an agreement on a set of rules which the SEHK was willing to propose and the SFC was willing to approve. See New GEM exemptions[17] (*Webb-site.com*, 30-Jul-01)

The final rules provided an exemption from the 2-year track record if a company was large enough (which carries the incorrect implication that large companies are less risky than small ones – tell that to Enron). Clearly this was designed to allow the type of rapid conglomerate spin-offs favoured by tycoons, rather than SME financing.

The GEM index peaked at 1,021.74 on 24-Mar-00 and is now down 88.9% at 113.42 (22-Nov-02). Many of the recent GEM IPOs have only been possible with suspiciously tight placing arrangements, and public interest is minimal.

This is a classic demonstration of the "adverse selection" problem, or in the words of George Akerlof, the "Market for Lemons". Given a lack of confidence in the regulatory structure, and a perceived information asymmetry between investors and issuers, the good issuers and professional investors stay away, leaving the GEM to the confidence tricksters and anyone else desperate enough to try to use the market. It's the same

[15] http://webb-site.com/articles/waiversgalore.htm
[16] http://webb-site.com/articles/waiver2.htm
[17] http://webb-site.com/articles/GEMexempt.htm

reason you'd rather by a used car from an authorised dealer than a private seller. Akerlof was co-winner of the 2001 Nobel Prize in Economics[18] for this 1970s work.

3.3 HKEx conflict of interests 2: listed v rule-making

The second conflict for HKEx is that it is governed by the Listing Rules which are made by its subsidiary, SEHK. If it makes proposals (through the LC) to amend the Listing Rules, which are then approved by the SFC, then HKEx will be governed by those rules. For example, if the HKEx proposed to make quarterly reporting mandatory, then it will be bound to report quarterly, and if it proposes that all proxy votes should be counted by way of a poll (rather than ignored) then it will have to do so in its own general meetings. In short, it may propose or resist changes which could affect its own listing obligations.

3.4 The Listing Committee is biased

There are essentially two sides to the HK market: listed issuers (and their controlling shareholders) and investors. As set out in the rules, each member of the LC represents a particular vested interest. Most of these interests are highly correlated with the interests of controlling shareholders, who run listed companies, and decide who they use as accountants, lawyers, investment bankers and brokers. It stands to reason then, that the lawyers, accountants and bankers whose firms gets almost no business from investors are likely to side with issuers when it comes to amending or interpreting the rules. Even brokers make the bulk of their profits from new issues and advisory business, and much less from secondary market activity. Their allegiance to issuers is underlined by the ongoing problem with independence of research.

As a maximum of 4 members of each LC may be fund managers out of 25 (on the main board) or 21 (on GEM), they are in a tiny minority. As noted, currently only one main board member is a fund manger.

3.5 Rule making by part-time Committee

The LC is in a position to water down Listing Rules proposals from the executive staff of SEHK, before they are submitted to the SFC for approval. If it wants, the LC can simply decline to make any proposal at all.

Here we have a body of part timers, who meet at 4.30pm each Thursday (in two Pools, so that each member attends once every two meetings) and have the power, through their control of the Listing Rules, to determine the future credibility of HK as a financial centre.

3.6 Current structure impedes Listing Rule reform

The prolonged delay before the new GEM rules were announced demonstrates clearly that despite being the statutory regulator of HKEx and SEHK, because the SFC cannot direct SEHK to amend its Listing Rules, the SEHK has the upper hand in any negotiations.

This has been illustrated in other cases, such as proposals to tighten the Listing Rules. On 26-May-99, SEHK announced[19] the publication of a consultation paper[20] on the Listing Rules, with consultation closing (after extension) on 31-Aug-99. I made a submission. Probably due to objections from issuers, the results of that consultation

[18] http://www.nobel.se/economics/laureates/2001/public.html
[19] http://irasia.com/regbod/hk/sehk/press/p990526.htm
[20] http://www.hkex.com.hk/library/listpaper/conpaper3.htm

were never published, although some parts of the proposals found their way into later consultations.

On 21-Jan-02, SEHK announced[21] on a new consultation paper on the Listing Rules relating to corporate governance (including some proposals made in the 1999 paper). Consultations closed (after extension) on 24-May-02. Although the CEO of HKEx has made various speeches hinting at the current position of HKEx, there has still been no announcement of the outcome or summary of responses or approval by the SFC of changes to the Listing Rules. However, the general indication in such speeches is that the proposals, which were already weak, are to be further watered down. For a detailed discussion of the proposals, see five articles on Webb-site.com in the Listing Rules[22] section.

In summary, HKEx has a history of consulting without concluding and proposals that place form over substance.

3.7 Admission to listing – subjective or objective?

On the one hand, the SEHK claims to be running a "disclosure-based" market where any candidate which meets the listing criteria must be admitted, but on the other hand, the LC can reject any application for listing on the grounds of "suitability". If we had a true disclosure-based regime with clearer rules on what constitutes a qualifying track record (and what should be excluded), then it should be a simple administrative process for the regulator to confirm that a candidate satisfies the entry criteria, and no external committee would be needed to pass judgment. Any applicant not satisfied with a ruling could seek judicial review.

3.8 Listing Division in tick mode

Despite the proposed dual filing system, by leaving SEHK with the role of front-end vetting of announcements, very few alarm bells will be raised. The SEHK simply doesn't look under the rocks and see the snakes. It's a "don't ask, don't tell" system.

SEHK could, of course, hold up clearance of announcements or approval of listing of new issues by existing listed issuers, until it was satisfied that it had all the necessary information, but to my knowledge they seldom do so. For example, one of the most popular ways to expropriate cash from a listed issuer is for the company to buy assets at inflated prices from nominee or corporate "independent third parties" who are in fact fronting for the controlling shareholder. The SEHK seldom probes the beneficial ownership of such parties, and accepts at face value an issuer's statement that the third party is independent, however ridiculous or uncommercial the transaction may be.

The Listing Rules do not require disclosure of beneficial ownership of counterparties. In response to my inquiry on this matter, the Listing Division told me:

> "Essentially, the statement of independence in the announcement will serve as the issuer's confirmation to us that the entity is independent. In some cases, we may obtain details of beneficial ownership of corporate counterparties for the file."

My overall characterization of the Listing Division is that they lack industry experience and are unable to see the wood for the trees. They proceed with "tick-mode" compliance, and once all the ticks are on the sheet, they are satisfied. They are unable

[21] http://www.hkex.com.hk/news/hkexnews/0201212news.htm
[22] http://webb-site.com/articles/listlistingrules.htm

to see the commercial structure of transactions and to question those which are obviously suspicious. With the exception of a few senior members, the staff turnover appears high (the Expert Group should ask for length-of-service statistics for all staff) and this probably reflects low morale and poor conditions of employment. In the past (in more buoyant markets) middle-tier investment houses would regularly poach the middle-ranking staff, so that accumulation of experience was limited.

In some markets, a secondment to the regulator for a year or two is a great credit to a professional CV, but this does not appear to be something that Hong Kong's professionals aspire to.

Although I am obviously critical of their performance, I do try to help. About once a week I come across obvious problems with corporate disclosure (either from my own reading or from readers of Webb-site.com), report them privately to SEHK and in about half of these cases, an announcement is made by the issuer concerned.

3.9 Disciplinary and interpretive role of Listing Committee

The LC currently also deals with disciplinary matters. By being so biased towards issuers in its composition, it is naturally disinclined to publicly sanction them. In any case, as noted, such sanctions have no real deterrent effect. Assuming that HK moves to introduce statutory backing for the Listing Rules administered by the SFC, then I see no reason to have an external committee to administer sanctions.

The LC also deals with appeals of rulings by the Listing Division on interpretation of the Listing Rules. Again, the LC's vested interests do not want to set precedents for the way their own issuer clients or listed companies may be treated in future, and they normally side with issuers rather than investors. A recent example is the Boto[23] case, where the LC declined to give the benefit of the doubt to public investors, and instead allowed close relatives of the Chairman and a fellow director and senior management to vote on a controversial transaction. I led a rare campaign to stop it, but because of the management and family votes, we lost the vote 53%:47%, even though public shareholders were overwhelmingly opposed to the sale.

3.10 Non-financial sanctions are ineffective

The sanctions available to both SEHK under the Listing Rules and SFC under the Codes are ineffective. A potential offender will act according to his perceived value of incentives and deterrents. For example, take a cash-strapped controlling shareholder who is considering "borrowing" money from his listed issuer without seeking minority shareholders' approval. On the one hand, he may not be able to raise funds any other way, and this provides access to millions of dollars. On the downside, if caught, he may get a public censure in the newspapers by SEHK, by which time the loan has gone bad. It is a simple choice to make.

Similarly, under the Takeover Code, if someone has crossed the bid threshold and failed to make an offer, then he has breached the Code. The Panel may issue a Cold Shoulder order for, say, 5 years, which will be lifted if he makes a general offer at the highest price he paid. It is a simple choice to make. A general offer costs real money, while he can always get a friend or relative to open a securities account for him, or even get his listed company (which he now controls) to trade in the market instead.

[23] http://webb-site.com/articles/0585.htm

If these two cases sound hypothetical, then instead consider, for example, the cases involving Mansion House Group Ltd[24] and Shun Ho[25].

3.11 Shareholder remedies are unaffordable

Shareholder legal actions, or the lack of them, form a key part of the regulatory dynamics in any market. In constructing the overall deterrent to abuse of listed companies, societies can choose a combination of statutory rules, criminal prosecutions (leading to jail) and civil enforcement through class actions. To some extent, strength in one of these areas can compensate for weakness in another – it is the perceived overall deterrent that is important. Unfortunately, HK is weak in all of these areas.

Whilst there are various legal avenues theoretically open to HK investors to seek their own remedies, these avenues are in fact cul-de-sacs. No single investor, or small group of investors, is able to justify the costs involved in taking legal action relative to the dollar size of their individual claims. This is the classic "plaintiff fragmentation" problem. Together, investors in a company may have suffered hundreds of millions of dollars in damages, but individually, they cannot justify spending the tens of millions that it may take to go through three layers of courts, while the defendant often finances his defence out of shareholders' funds.

The very rare legal action we see by shareholders in HK-listed companies usually involves one or more well-funded large (20%+) shareholders battling for control of the company.

3.12 Statutory right to derivative action

The Standing Committee on Company Law Reform[26] ("SCCLR") has proposed that shareholders be given a statutory right of derivative action on behalf of the company in which they have invested. However, these actions would still need to be financed until a win is secured. Secondly, even if the case is won, and the company receives the award of damages, the company is likely still to be controlled by the people who caused the damage in the first place, who may then set about expropriating the assets again.

Obviously any new legal right cannot have negative value, so I welcome it, but I personally doubt that many investors will find it worthwhile to use the statutory derivative action.

3.13 Class actions allow private-sector enforcement

Class actions in the USA have gained a bad reputation for frivolous law suits, but one key difference is that the USA does not have a loser-pays system, whereas HK does. A loser-pays system, whereby an unsuccessful plaintiff has to pay the defendant's costs, would deter frivolous actions in a class-action system.

If HK were to allow class actions, together with contingent legal fees, but retaining the loser-pays system, then lawyers would be able to make a calculated and commercial decision on the merits of a case, and decide whether to finance the case (and the potential costs of losing) in return for a no-win-no-fee deal.

I note that a senior official of the CSRC said last week that the mainland regulator is considering introducing a formal class action system. This follows on from other

[24] http://www.hkex.com.hk/news/hkexnews/0419news.htm
[25] http://www.hksfc.org.hk/eng/takeovers/html/takeovers/shunho2.htm
[26] http://www.info.gov.hk/cr/notice/scclr/content.htm

moves to enhance the mainland market, including quarterly reporting since 1-Jan-02 and deregulation of brokerage rates since 1-May-02.

3.14 Quasi-class actions through a representative body

In 2001, I proposed an alternative to the introduction of full class actions, in the form of a quasi-class action constructed as a massive joint action on behalf of members of a levy-funded body to represent investor interests, the Hong Kong Association of Minority Shareholders. For more on this proposal, see HAMS[27] on *Webb-site.com*.

HAMS would also represent investor interests in the policy debate – which means that instead of me writing submissions like this one, an authoritative investor body, governed by investors and professionally staffed, would lobby full-time and respond to all proposals made by industry regulators and affecting investors, including the Government, SCCLR, SFC, HKSA and Law Society (and HKEx, if it is still a regulator). Any investor could join for a nominal fee, and half the governing body would be elected by individual investors and half by institutions.

The proposal met with widespread endorsement from different sectors of the investment community, both privately and (where conflicts permitted) publicly[28]. However, in order to overcome the "free-rider" problem, to provide sufficient resources and to make it a user-pays system, HAMS had to be financed by a market levy (as are the HKEx and SFC), proposed to be 0.005% on each trade, or just 0.01% of the free float market capitalization per annum. A levy requires legislation, and the Government rejected the proposal. Investors were more than willing to pay the levy to finance their own representation, but Government simply wasn't willing to enable it. In its response, the Government leant on the SCCLR, which is dominated by issuer interests.

3.15 The Constitution of the SFC

At present, the Chairman and directors of the SFC are only as secure in their jobs as their relationship with Government allows, as the CEHK can appoint or remove them and direct the SFC. This does not make them independent of Government, and the regular meetings with the FSTB on policy make it clear who is in charge. To most outsiders, the SFC is subordinate to Government, and boat-rockers are not welcome on its board. The SFC is kept on a short leash by Government, and that means that the Government ultimately decides how far the SFC goes to pursue its remit

Hongkong has an unelected Executive Branch, and as such it lacks public accountability through the ballot box. The only direct representation is through the directly elected members of LegCo, but LegCo has no say over who runs the SFC.

The Government has been and will continue to be a major player in the equity market. In 1998 it pumped HK$120bn of public money into the market, buying an estimated 15% of the free float with the stated goal of boosting the 33 companies in the Hang Seng Index (but not other stocks) to squeeze index short positions, and at the time asserted that the Government was not subject to the laws on disclosure of interests or market manipulation. The SFC, which normally prosecutes breaches of the Securities (Disclosure of Interests) Ordinance[29], was hardly in a position to contest this. For several weeks, investors had no idea what the Government owned or how much had

[27] http://webb-site.com/HAMS/
[28] http://webb-site.com/HAMS/thelist.htm
[29] http://www.justice.gov.hk/blis.nsf/CurAllEngDoc?OpenView&Start=396.1.1&Count=59

been spent, although we knew it had acquired more than 3% of HSBC because it had to disclose that under UK law. It later emerged that they had acquired more than 10% of three companies' shares.

The Government controls one listed company (MTRC) which may shortly be merged with a government-owned company (KCRC). With a growing fiscal deficit, the government is expected to tap the equity markets in future and may control listed entities such as HK Airport, HK Water, HK Disney or HK Post. It also has *de facto* control of the HKEx through its appointment of a majority of the board, although it owns no shares in HKEx. The Government also holds billions of dollars in equities through the Exchange Fund, and has stated an intention to do so indefinitely.

For these reasons, the executive Government should distance itself from the regulatory process. In the US, the Commissioners of the SEC[30] are nominated by the President and approved or rejected by the Senate. Not more than 3 out of 5 can be from the same political party.

3.16 Government involvement in Rule Making

I have heard claims by the Government that they have no involvement in proposing changes to the Listing Rules, which are simply a matter for the LC. In reality, this refuted by facts. Just one day before the proposals on delisting criteria were announced, on 24-Jul-02, the Government, HKEx and SFC jointly announced, in a press conference in Government offices, that changes would be made to the whole Listing regime, which will require extensive changes to the main board and GEM Listing Rules, in particular the chapters which set out the composition and powers of the various committees. These changes in fact reversed proposals announced[31] by HKEx on 6-May-02, before the SFST came into office on 1-Jul-02.

While it may be true that the management of HKEx and the Government do not choose to involve themselves in minor amendments to the Listing Rules, it is also true that they can do so at any time. The Listing Committees of SEHK do not act in isolation. They normally only meet once a week, and the proposals put to them are crafted by the Listing Division of SEHK, a subsidiary of HKEx. The staff of the Listing Division report to the Chief Executive of HKEx.

3.17 Government preserved brokerage cartel

Another example of Government exercising its control of HKEx is the decision to delay deregulation of brokerage commissions in early 2002. Although it was clearly a government decision, the minimum commission rate is in fact set out in Rule 534[32] of the Rules of the Exchange, so amending that rule is theoretically a matter for the SEHK subject to SFC approval. Recently, even the Chairman of HKEx has admitted that this is a "political issue" (*HK Standard*, 13-Nov-02).

3.18 Reform is a matter of political will

The reality of reform is that it can only happen if the political will is there. When the Government wants to do something, then it can move quickly. For example, the merger and legislation which created HKEx was completed in less than a year. However, if vested interests (many of whom are on the Selection Committee which appoints the CEHK) are leaning on Government to slow down, then things can happen very slowly.

---

[30] http://www.sec.gov/
[31] http://www.hkex.com.hk/news/hkexnews/020506news.htm
[32] http://www.hkex.com.hk/rulereg/rulesex/chap-5_eng.doc

3.19 Use of SFC's and Financial Secretary's Statutory Powers

It remains to be seen whether the SFC will be any more aggressive in intervening to defend shareholder interests (for example, by taking action to seek a remedy for unfair prejudice against minority shareholders) after using the strengthened powers of investigation under the new Securities & Futures Ordinance. It has been six years since the Mandarin Resources case began in 1996, and it can hardly be argued that there are no cases since then which justify such treatment.

3.20 Co-ordination with law enforcement

There also appears to me to be a lack of co-ordination between the SFC, the Commercial Crime Bureau and the ICAC. It is not clear to the public, in cases of suspected corporate fraud involving listed companies, to whom they should report the case. Fraud can also involve bribery or hidden advantages, so arguably all three apply. Furthermore, it is not clear to the public whether if one agency concludes that it cannot act, that it will pass the case to another agency or just file it. Greater clarity is needed.

3.21 The competitive threat from mainland China

It is worth commenting on how the pace of reform here impacts on our competitive position with mainland markets. In some respects, such as quarterly reporting, the rules on independent directors and negotiable brokerage rates, the mainland is already ahead of HK. All the corporate governance rules are promulgated by the CSRC, not the two exchanges, and with the minimum of fuss from issuers, most of which are controlled by the Government anyway. If there is a mandarin word for "U-turn", they don't use it often.

However, HK currently has two strategic advantages. First, the mainland has capital controls, and we don't. Secondly, we have an experienced and reliable (albeit expensive) judicial system used to dealing in commercial disputes and corporate law, while the mainland doesn't. Both of these advantages could disappear.

On the back of surging foreign reserves, within the next 5-10 years, China is expected to remove capital controls. It will also likely merge its two exchanges and three share classes (A/B/H) into one and continue the privatisation of state-owned enterprises. On the legal front, it may outsource legal work, for example by incorporating its listing vehicles in HK (or elsewhere) and listing in Shanghai, or it may choose to fast-track the PRC corporate courts to provide judicial training for a reliable and predictable legal system. At the end of the day, for investors in mainland businesses, the domicile of the issuer is less important, because the underlying assets (subsidiaries, properties, licenses, whatever) will all be under PRC jurisdiction.

---

4. Conclusions and Recommendations

I have now stated the facts and made observations on the situation. This section deals with the conclusions that must be drawn from this, and my recommendations on the consequent changes needed to our regulatory structure.

4.1 The HKEx should exit regulation

The Listing Division of the HKEx should be merged with the Corporate Finance Division of the SFC. It will then be necessary to review the staffing, improving the overall quality and hiring more experienced professionals. The CFDSFC must be given sufficient financial resources to do the job.

Inevitably, all of the Listing Fees and part of the transaction revenue of HKEx may be needed by SFC to do this. As I do not have access to the financial data on this, I cannot offer further comment.

4.2 Listing Rules and Codes should have statutory backing

Our system of sanctions has been shown to be ineffective. The Listing Rules and the Codes should have the force of law. The SFC may then choose to use non-financial sanctions in mild cases, or financial penalties in the worst cases, for breaches of the Rules and Code. The SFC would of course be subject to judicial review, but it is usually fairly clear when a Listing Rule has been broken. It is important that fines be levied against those who caused a breach, usually executive directors of listed issuers, rather than the issuer itself. To fine an issuer is to fine minority shareholders, and this should be avoided.

I am in two minds about whether there should be a continuing role for an external disciplinary committee to handle appeals of the SFC's disciplinary rulings, or to make rulings and issue penalties in the first instance, on breaches of the Listing Rules and the Codes. On the one hand, it seems inappropriate for a body of part-time individuals to issue financial penalties, in the style of the Market Misconduct Tribunal. It may expose those individuals to explanation of their actions in the courts under judicial review. On the other hand, it may be beneficial to shield the courts from at least the first round of appeals. On balance, it seems to me that a disciplinary committee is redundant, and if anything, the appeals should be brought within the framework of the Market Misconduct Tribunal, which is chaired by a Judge, but only when the sanction involves fines rather than reprimands.

So the path would be: (1) SFC finds breach of Listing Rules or Codes, and issues sanction (may include fines); (2) in case of financial penalties only, defendant has automatic right of appeal to Market Misconduct Tribunal; (3) after finding of MMT, defendant has usual rights to judicial review.

4.3 Listing Rules should be made by SFC

We need a body of neutral, full-time professional regulators to make our rules, not a body of part-timers with vested interests. The SFC should continue to consult widely before making or amending the Listing Rules, but at the end of the day it should make a decision. To provide the voice of issuers, the SFC could form an "SFC Issuers Group" to parallel the existing SFC Shareholders Group. Both would be advisory committees to the SFC, and neither would have rule-making power.

The Takeover Code, as at present, would be amended by the SFC after market consultations. Proposals would be made after consultation with the Issuers Group and Shareholders Group.

There is a great deal of work to be done to raise our Listing Rules to international standards. These problems are beyond the scope of this paper but I would be happy to refer you to previous material on this. There are also numerous areas which provide scope for "regulatory arbitrage" between the Listing Rules and the Takeover Code, and these need to be eliminated as much as possible. In essence, we need a consolidated and consistent regulatory rulebook.

If we consolidate the rule making process under the SFC, then this will at least bring clarity to one issue: after that, if reform is still not happening, it will then be because Government is not supporting it. One could no longer blame a rule-making Listing Committee that does not exist, or an exchange that was fighting the SFC – both would be out of the equation, and the tycoons' only way to impede reform would be through the ear of a Government which in turn leans on the SFC.

4.4 Listing Rules should be administered by the SFC

As we are aiming for a true disclosure-based system, I see no need for an external committee to make subjective judgment on new listing applications, or on the interpretation of the rules. The SFC should perform both roles, and again would be subject to judicial review.

4.5 The Listing Committee and Panel should be scrapped

It follows from 4.2, 4.3 and 4.4 that the LC and Takeover Panel should be scrapped. There would be nothing left for them to do. Existing members of the LC and Panel could instead join the pool of available laypersons to serve on the Market Misconduct Tribunal.

4.6 HKEx should delay merged Listing Committee pending Expert Group report

Having regard to 4.5, and as the role of the LCs is under review by the Expert Group, it seems inappropriate for HKEx (to propose) and SFC (to approve) Listing Rule changes needed to implement the merged LC as announced on 24-Jul-02 and scheduled for 1-Jan-03. The Expert Group is not due to report until Mar-03, so you should consider making an interim recommendation to delay implementation of the merged LC pending your final report.

4.7 Staff secondments

A program of secondments of middle-level executives from the investment banking, accounting and legal sector to the merged CFSDFC should be initiated, in order to improve the staff's experience and understanding of the industry they are regulating. I suspect skills and salary levels are, on average, lower in the Listing Division of SEHK than in the current CFDSFC. Salaries in the merged CFDSFC should be commensurate with industry levels.

4.8 The SFC should be independent of Government

The Directors of the SFC should be nominated by CEHK but subject to approval by LegCo. They should be removable by CEHK but only with the consent of LegCo, except in circumstances of disqualification such as being declared bankrupt, insane or convicted. They should be full-time professionals with no outside businesses. The appointments should be for staggered terms to avoid discontinuity.

The SFC should not be subject to directive by CEHK. There needs to be a separation between the appointment of its directors and direction by its directors.

4.9 Negotiable commissions

I strongly believe that the minimum brokerage rule, in any form, whether for all trades, or for trades below a certain size, is an anti-competitive practice that breaches the principle of a free market economy. Price-fixing is untenable and economically indefensible. For more history and detail, see the Dealing Costs[33] section of Webb-site.com. The rule must be scrapped without further delay.

4.10 Class actions

The law should be amended to allow shareholder class actions. In the alternative, legal action should be facilitated through quasi-class-actions by enabling the HAMS proposal. Shareholder activism through class actions would provide more balance to the system through added deterrent.

4.11 Contingent fees

Lawyers should be allowed to work for contingent fees, on any basis they can negotiate with their client. We claim to be a free market, so we should not prohibit such negotiation for services.

4.12 Punitive damages

The law should also be amended to allow the possibility of punitive (multiple) damages in civil claims. This is for the simple reason that if the probability of being caught and sued for abusing a company is less than 100% (which it is) then the financial penalty must be more than the amount gained from such abuse. Otherwise, absent all other factors, the logical calculated decision is to go ahead and abuse the company.

5. Closing remarks

You will of course receive representations from vested interests on the issuer side claiming that the status quo is fine and that over-regulation would kill the market. Let me assure you that it is already dying and in urgent need of regulatory organ transplant. Investors are increasingly cynical about the quality of stock offerings and the degree of investor protection and legal rights in HK.

For overseas institutions, both in financial and geographical terms, HK is just a small dot on the global radar screen. China is a potentially far bigger blob, and whether its financial services sector gravitates to HK or Shanghai depends a lot on the relative pace of reforms here and in the mainland.

Domestically, HK workers are avoiding equity elements in their MPF schemes after dismal performances since the schemes were launched. We are not creating the conditions to foster confidence in the stock market as a long term savings vehicle. The radical restructuring of the regulatory and legal system that I have called for in this paper would go a long way to stimulating that confidence.

[33] http://webb-site.com/articles/listdealingcosts.htm

In HK, we are now running a strong risk of ending up as the Florida of China rather than the Manhattan of China – a pleasant place to visit on holiday, with an ageing population, warm weather, a cruise terminal or two, a theme park, a few fund managers but no longer being China's financial services hub.

Yours faithfully,

David M. Webb

Editor, Webb-site.com
Member, SFC Shareholders Group
Member, Takeovers and Mergers Panel
Member, Shareholders Sub-Committee of the Standing Committee on Company Law Reform