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財經事務及庫務局

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7 December 2016

Ms Connie SZETO
Clerk to Panel on Financial Affairs
Legislative Council Complex
1 Legislative Council Road
Central
Hong Kong

Dear Ms SZETO,

**Panel on Financial Affairs
Follow-up to meeting on 15 November 2016**

I refer to your letter dated 16 November 2016 and enclose for members' information a copy of the response of the Financial Services Development Council to the consultation paper on "Proposed Enhancements to The Stock Exchange of Hong Kong Limited's Decision-Making and Governance Structure for Listing Regulation", which was jointly issued by the Securities and Futures Commission and the Stock Exchange of Hong Kong in June 2016.

Yours sincerely,

(Andrew WU)

for Secretary for Financial Services and the Treasury

Response to SFC/HKEx Joint Consultation Paper issued in June 2016:

Proposed Enhancements to The Stock Exchange of Hong Kong Limited's Decision-Making and Governance Structure for Listing Regulation (the "Paper")

Background

1. The Financial Services Development Council ("FSDC") deliberated at its July 5, 2016 Council meeting the content of the Paper jointly issued by the Securities and Futures Commission ("SFC") and the Stock Exchange of Hong Kong (the "Exchange") in June 2016. The FSDC welcomes efforts by the SFC and the Exchange to improve the listing regulatory regime in Hong Kong.
2. The FSDC's mission is to strengthen Hong Kong's position as an important international financial centre and to promote the sustained development of the financial services industry of Hong Kong. Our interest in the Paper centres on improving efficiency of the current regime and increasing clarity on the governance of the listing function, both of which would help to enhance the quality of our market. We consider quality of the market to be the bedrock of Hong Kong's status as an international financial centre.
3. The current listing regime was designed in the mid-1990's to cater for the unique features of the Hong Kong market. The regime involves vetting of listing applications by the executives of the Listing Department (the "LD") of the Exchange and approval of listing by an independent Listing Committee (the "LC") comprising of market practitioners and professionals. Any objections to the decision of the LC are reviewed by a separate group of LC members under the Listing (Review) Committee or the Listing Appeals Committee, as the case may be. Any changes in policy and the Listing Rules proposed by the Exchange require the approval of the SFC. This framework has largely served the market well.
4. However, the Hong Kong securities market today is much larger and more complex than that of twenty years ago. At the same time, it has

been noted that in recent years the decision-making process of the LC has evolved, and that there is a lack of clear articulation on the respective accountability of making policy changes among the LC, the Exchange, and the SFC. Recently, certain market commentators have also pointed to the extreme volatility in the stock price and the controversial corporate behavior of many newly listed companies, and questioned the decision by the LC in allowing those companies to list. Against this background, we consider that a review of the current regime with a view to enhancing and improving the listing process and governance of the listing regulatory structure is desirable and would be welcomed by the market.

5. As stated in the FSDC Paper “Positioning Hong Kong as an International IPO Centre of Choice” (FSDC Paper No. 09, June 2014), there is considerable capacity for further developing our market by addressing and improving IPO practices, introducing suitable flexibilities, and correcting structural and legal weaknesses, among other things.
6. The FSDC believes that any improvement and enhancement to the current listing regime must take into consideration the competitive nature of the global market today. In order to maintain Hong Kong’s attractiveness as a reputable and desirable venue of choice for raising international capital, a fresh regulatory approach would be needed to tackle challenges posed by potential listing applicants in the new economy/industries, while maintaining quality in our regulatory standard.
7. The Paper sets forth four objectives, namely (a) to achieve closer coordination and cooperation between the SFC and the Exchange on policy formulation; (b) to streamline the process for making important or difficult listing decisions; (c) to simplify the vetting process for IPO applications in order to achieve better efficiency; and (d) to establish clearer accountability for decision-making within the Exchange and enhance oversight of the administration of the Listing Rules.

8. These are laudable goals. However, the FSDC is of the view that the proposals set out in the Paper (the “Proposals”) may not achieve the stated objectives. We set forth our specific comments below.

The Listing Regulatory Committee

9. In relation to listing matters concerning new listing applicants or listed issuers, the Proposals envisage adding a new committee above the LC, namely, the Listing Regulatory Committee (“LRC”). The new LRC would essentially turn the approval of listing applications from the current two bodies/two steps (LD/LC) process into a three bodies/three steps (LD/LC/LRC) process.
10. We would not support the creation of the new LRC. A comparison of the “Present” and “Proposed” process flow charts in **Appendices 1A** and **1B** to this submission shows clearly that instead of streamlining the listing process, the proposed structure would in fact add an extra layer in the form of the LRC, with additional work in the listing process. It would be difficult to argue that the proposed structure would improve efficiency of the listing process.
11. Under the proposed structure, other than the routine vetting of listing applications, the LC would make “non-binding views” to the LRC on matters having suitability concerns or broader policy implications. A similar structure is replicated with regards to listing policy matters with the creation of the Listing Policy Committee (“LPC”), as further explained in paragraphs 20 to 23 below. Such a structure would emasculate the authority of the LC in both the listing approval process and the policy formulation process, and would effectively reduce the LC to an intermediary body. We believe this structure would make it more difficult to attract practitioners and professionals to serve on the LC.
12. The Paper emphasized that the LD together with LC will continue to decide “a large majority of IPO applications and post-IPO matters”. Under the proposed structure, the LD will be responsible for deciding if a matter should be referred to the LRC. If a matter is referred, the LRC would be accountable for its decision. If not referred, the decision would

be made by the LD and the LC, which will be accountable for the decision. This would in fact induce LD executives to err on the safe side and refer more matters to the LRC than under the current regime.

13. The difficulty of LD executives in deciding whether to refer matters to the LRC is further exacerbated by the fact that oversight of their work and evaluation of their performance (and hence their salary review) would be done by the LPC. We find this part of the Proposal most troubling. It violates basic governance principle and blurs the accountability line when the staff of one organization would be evaluated by a committee comprising mostly of external parties half of whom are their regulator.

SFC's Role in the Listing Process

14. Under the current regime, the SFC has the power to reject any listing applications and to approve or reject rule changes proposed by the Exchange. The SFC's power in policy formulation rests with the Board of the Commission, comprising both Executive Directors of the various divisions, as well as non-executive directors broadly representing the market. This framework ensures checks and balances on the executives, and provides inputs from more than one division within the SFC as well as the market perspective of its non-executive directors.
15. Having SFC executives as members of the LRC and LPC raises the following fundamental legal and governance questions which the SFC should clarify:
 - (a) Both LRC and LPC are committees of the Exchange. What is the legal status of the SFC executives sitting on these Committees? Should any decisions of these Committees be challenged, could SFC still maintain its position as regulator of the Exchange when it had taken part in making the decision?
 - (b) Would the SFC executives serving on LRC and LPC be acting under delegated authority by the Commission? If so, the benefit of inputs by the full Commission would be removed. If not, matters discussed at these Committees would ultimately need to be

referred back to the full Commission, hence adding another layer in the process.

16. There are currently two examples of SFC executives sitting on committees of the Exchange and its parent company the HKEx, namely, on the Listing Nominating Committee (with SFC and HKEx having equal numbers of members) of the Exchange and on the Statutory Risk Management Committee of the HKEx. However, neither of these committees are policy-making bodies: the former nominates members to the LC, the latter is a government-appointed body under Section 65 of the Securities and Futures Ordinance to oversee risk management of the markets operated by HKEx.
17. It is worthwhile to note that the July 2014 report on “Detailed Assessment of Observance” issued by the IMF in respect of Hong Kong under the Financial Sector Assessment Program states (in paragraph 18) that the SFC’s role in the HKEx Risk Management Committee could create potential conflicts vis-à-vis its supervision role. This concern would be echoed in the proposed LRC/LPC structure, where the SFC may find itself holding review or appeal jurisdiction over a decision in which it has previously participated through its representatives on these committees.
18. The importance of various governance safeguards within the SFC’s own decision-making process was also highlighted in the Report of the Panel of Inquiry on the Penny Stocks Incident of September 2002 by Robert G. Kotewall and Gordon C.K. Kwong (“PIPSI Report”), where the regulatory framework for listing decision-making at the time was reviewed. The Report noted that among the checks and balances that the Government introduced to ensure the soundness of the regulatory system was the measure that “[t]he more important decisions of the SFC have to be made by the full Board of the SFC, and are not delegable unless with the approval of the Legislative Council” (paragraph 3.17(b)).
19. Considering the governance concerns stated above, and in order to enable SFC to have more meaningful input, it might be useful for the Executive Director (“ED”) and one of the Senior Directors (“SD”) of the SFC Corporate Finance Division to attend LC meetings as observers, so that they would gain a better understanding of and may share their perspective on the issues discussed by LC members in vetting and approving listing applicants. The role of these SFC executives and the

mode of their participation in the LC meetings should be carefully designed in order to address the potential issues and conflicts identified in paragraphs 15 and 17 above.

The Listing Policy Committee

20. While the LRC would add layers to the listing process, by comparison the LPC is more straight forward. Comparison of the “Present” and “Proposed” listing policy formulation flow chart in **Appendices 2A and 2B** shows that LC will become an intermediate and additional step between the LD and LPC, and will only provide “non-binding comments” on the proposed policy being considered by the LPC.
21. Although we understand that the rationale for the LPC is for SFC executives to be involved at an early stage of listing policy development at the Exchange, we are not certain it is necessary to create a new committee for such purpose. If one must be created to facilitate better coordination and substantive discussion between the two parties, the composition of its membership ought to be more balanced in order to achieve such purpose. **Appendix 3** to this submission shows the membership composition of the new committees proposed in the Paper, which would appear largely dominated by the SFC. It is notable that there are few or no HKEx representatives on these committees which are, after all, committees of the Exchange.
22. While we would support closer cooperation between the SFC and the Exchange in shaping listing policy, we have considerable reservation on the CEO of the SFC serving on the LPC as an ex-officio member. Echoing our observations in paragraphs 15 and 17 above, we believe that the CEO of the SFC should remain outside of these committees in order to be in a position to review, as a disinterested party, any policy decision that may come to the SFC Board for approval.
23. Instead of, or in addition to the CEO of HKEx serving on the LPC, we consider it would be more appropriate for two non-executive directors of HKEx to serve as members of the LPC. This would be more desirable from the point of view of good governance and accountability of the HKEx Board.

Role of HKEx Board in Endorsing Listing Policy

24. For historical reasons, the LC, as an independent committee of the Exchange, does not involve the participation of, and is not subject to, the oversight by the Board of HKEx. The original intention of such structure was to insulate the Board of HKEx from interfering in the listing application process. It was not intended to exclude the Board from deliberating policy changes pertaining to the Listing Rules, which might impact on the business or the development strategy of the HKEx.
25. However, over the years the practice has developed into excluding the Board from discussing listing policy matters altogether, on the basis that a Chinese Wall between the LC and the HKEx Board was necessary to ensure that the Board would not place commercial and profit-making priorities over its public interest duty to safeguard the Hong Kong market. We believe this practice unjustified and unnecessary.
26. There is currently a three-prong safeguard in ensuring that the HKEx would take into consideration public interest in operating its business. The duty of the HKEx Board to discharge its function in the public interest is enshrined in Section 63 of the Securities and Futures Ordinance (see **Appendix 4**). Among other things, it is required to “(a) act in the interest of the public, having particular regard to the interest of the investing public; and (b) ensure that the interest of the public prevails where it conflicts with the interest of the recognized exchange controller.” This was the quid pro quo for HKEx to be given the monopoly of operating the securities market in Hong Kong by the Government.
27. In addition, the Government appoints six of its 12 directors (the 13th director being the CEO of HKEx as an ex-officio member of the Board), each of whom has the responsibility to ensure that HKEx complies with the requirements of the law. Furthermore, the Chairman of HKEx, although elected by the Board, is appointed by the Government; while the appointment of the CEO of the HKEx by its Board is subject to the approval of the SFC. A third layer of safeguard, ensuring that the HKEx Board would not disregard public interest in developing its policy, is that

any rule or policy changes of the Exchange would require the ultimate approval of the SFC, which holds the veto power to reject any policy changes that may infringe on public interest.

28. As the board of a listed company, the directors of HKEx have the fiduciary duty to decide the development strategy of the company. Institutional investors outside Hong Kong have often questioned how the Board of HKEx would be accountable for the company's strategic development when it plays no part in shaping this important aspect of its business. We believe it is time for this anomaly to be addressed. For purposes of the current review, we would suggest including two non-executive directors of HKEx on the LPC. This would enable the Board to play more of its proper role in developing strategic policy of the HKEx, while bearing in mind its duty to safeguard public interest, and would balance the composition on the LPC.

Governance Issue Not Addressed in the Paper

29. Tenure of LC Members

(a) For the past 10 years, most members on the LC have served on the committee for six years. While each member is appointed for a term of one year under the current rules, and indeed it is so specified in his/her appointment letter, the six-year rule of maximum tenure serving on government committees was somehow adopted by the Listing Nominating Committee. There is therefore an expectation by LC members that unless their attendance record was poor, they would serve on the LC for six years. This was not the intent when the LC regime was designed in the mid-1990's.

(b) It has been argued that it would be useful for LC members to gain experience over a longer tenure. However, such argument must be balanced with the consideration that LC members are already experienced practitioners when appointed, and that the LC, unlike most other government advisory committees, is a decision-making body whose members are privy to a large amount of market-

sensitive information. We believe rotation of members on a more frequent basis would help to minimize situations of conflict of interests and the perception of (mis)use of market-sensitive information by some LC members.

- (c) We strongly urge the SFC and HKEx to review this aspect of the LC as part of the current review exercise, in order to strengthen the governance structure of the listing function. We would suggest that LC members serve no more than two years, except in the case of the LC Chairman, who may serve an additional two years for a maximum of four years. Members could be reappointed after a two-years absence.

Suggestions by FSDC

30. The FSDC would like to offer the following suggestions for the SFC and the HKEx to consider in drawing the conclusion of this consultation exercise:

- (a) the SFC and the HKEx should articulate more clearly the regulatory objective(s) of the Proposals;
- (b) the SFC should clarify the position of its executives serving on the LRC and LPC, as discussed in paragraph 15 above;
- (c) Instead of creating the new LRC, the current LC may be expanded to include two SFC executives, as discussed in paragraph 19 above, thus preserving the SFC's authority as regulator should any decision of the LC be challenged; this will also remove one layer of process and accomplish the efficiency envisioned in the Paper;
- (d) the CEO of the SFC should not be an ex-officio member of the LPC, as discussed in paragraph 22 above;
- (e) LPC membership should comprise: Chairman of Takeover Panel, the ED of the Corporate Finance Division of the SFC, an SD in the

Corporate Finance Division of the SFC, the Chairman and 2 Deputy Chairmen of the LC, 2 non-executive directors of HKEx, and the CEO of the HKEx; this would be a more balanced representation of the stakeholders, as discussed in paragraph 23 above;

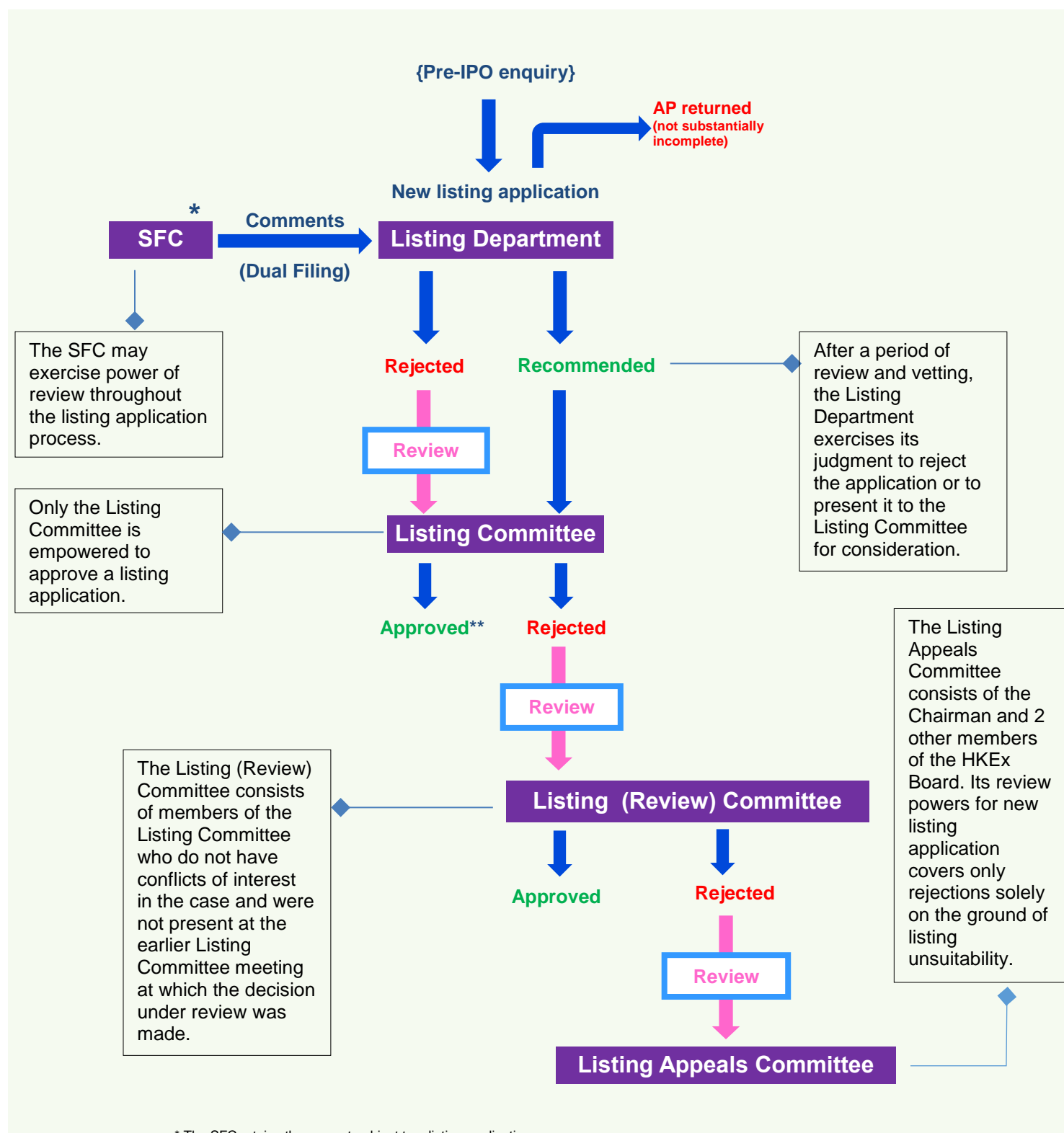
- (f) Evaluation of LD staff performance should be done by the Head of LD, with input from the Chairman and Deputy Chairmen of the LC; evaluation of the Head of the LD should be done by the CEO of the HKEx, with input from the Chairman and Deputy Chairmen of the LC; the LPC as a body should play no part in this evaluation exercise, as discussed in paragraph 12 above;
- (g) the HKEx Board should have a role in listing policy, as discussed in paragraph 28 above;
- (h) SFC/HKEx should clarify the tenure of LC members to be not more than two years, with the Chairman of the LC serving a maximum of four years, as discussed in paragraph 29(c) above.

Financial Services Development Council

September 9, 2016

Appendix 1A

The present listing approval + review process

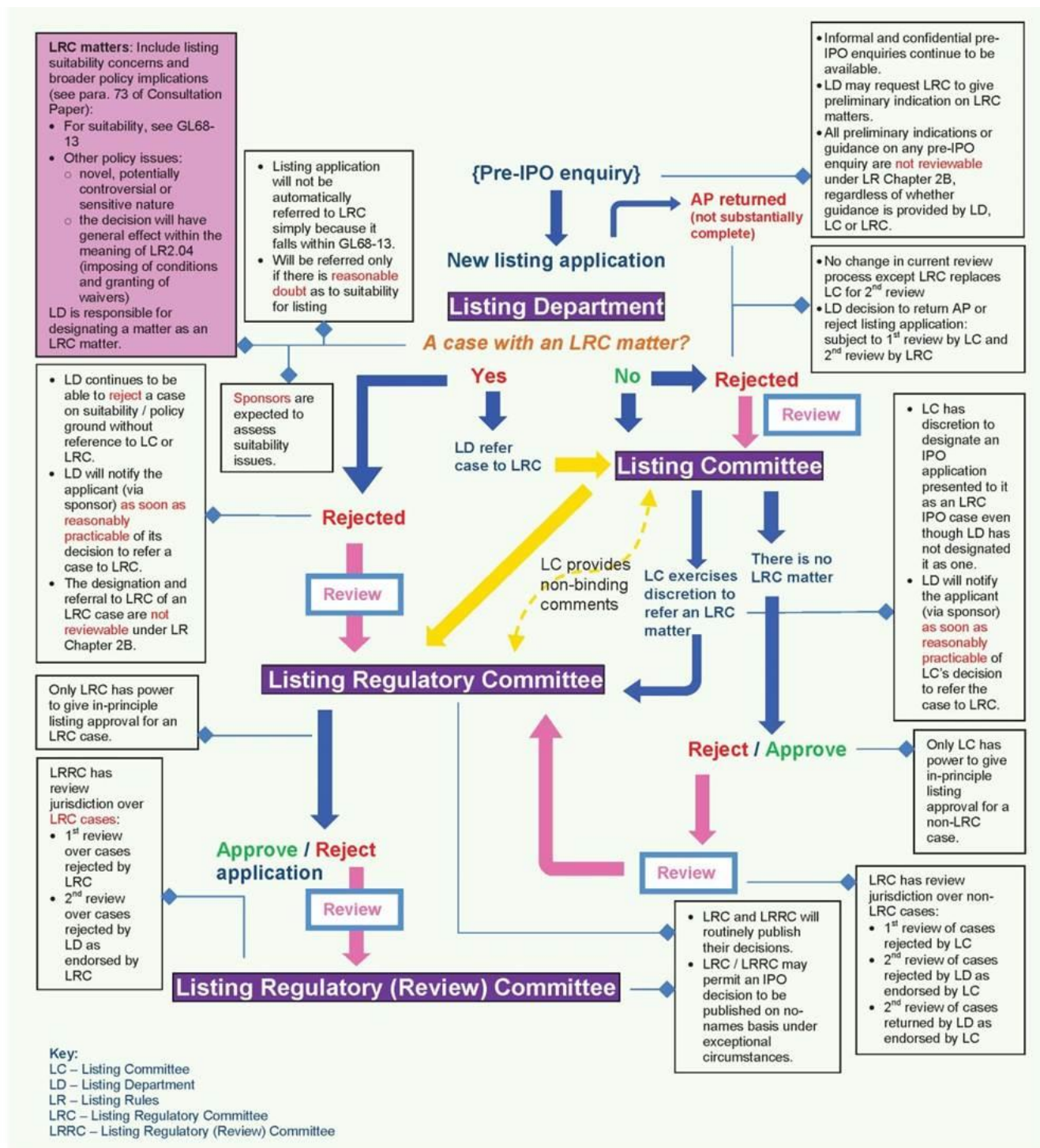


* The SFC retains the power to object to a listing application.

** If conditions are imposed, the case may go back to the Listing Committee for another hearing.

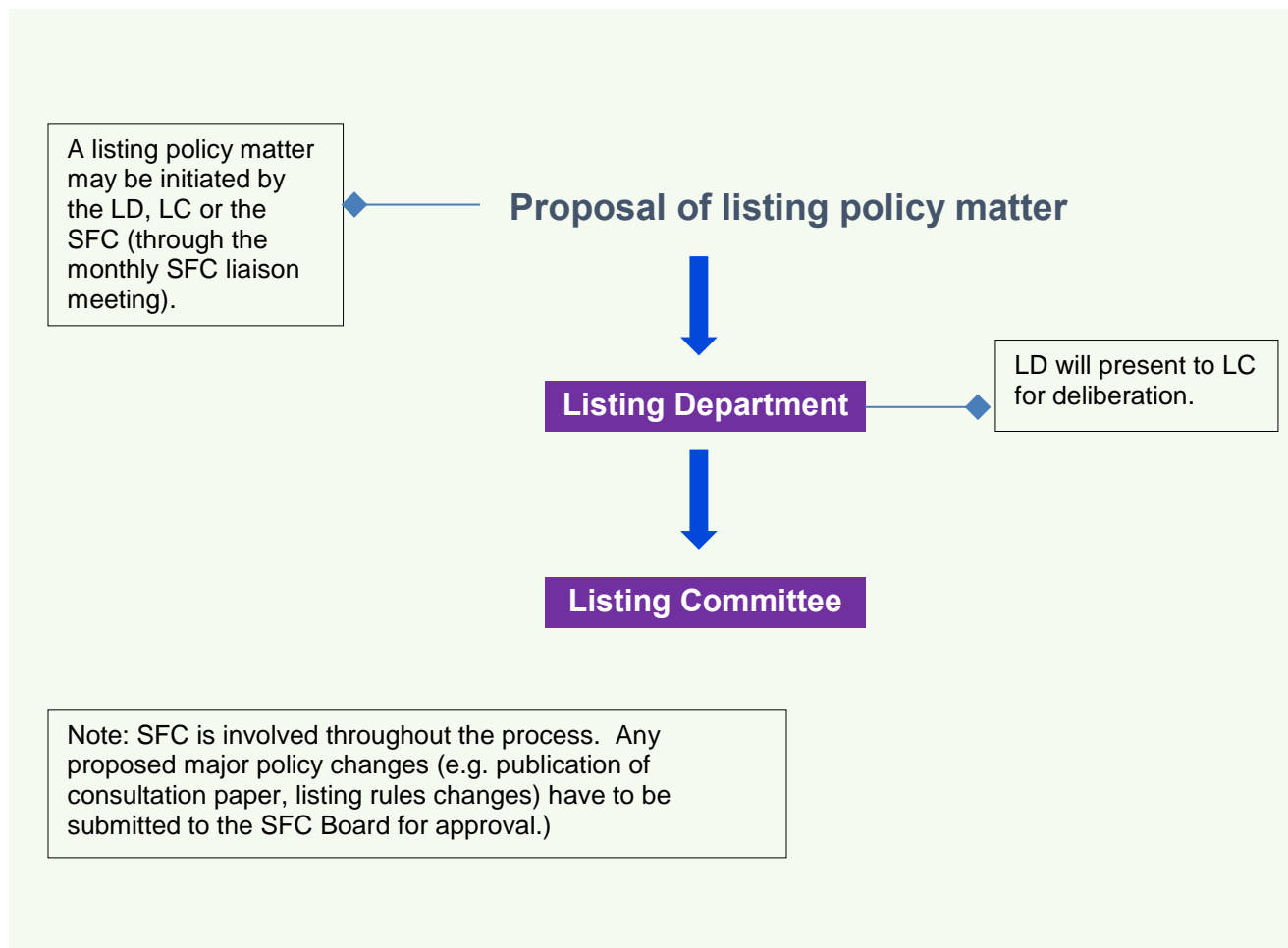
Appendix 1B

The proposed listing approval + review process



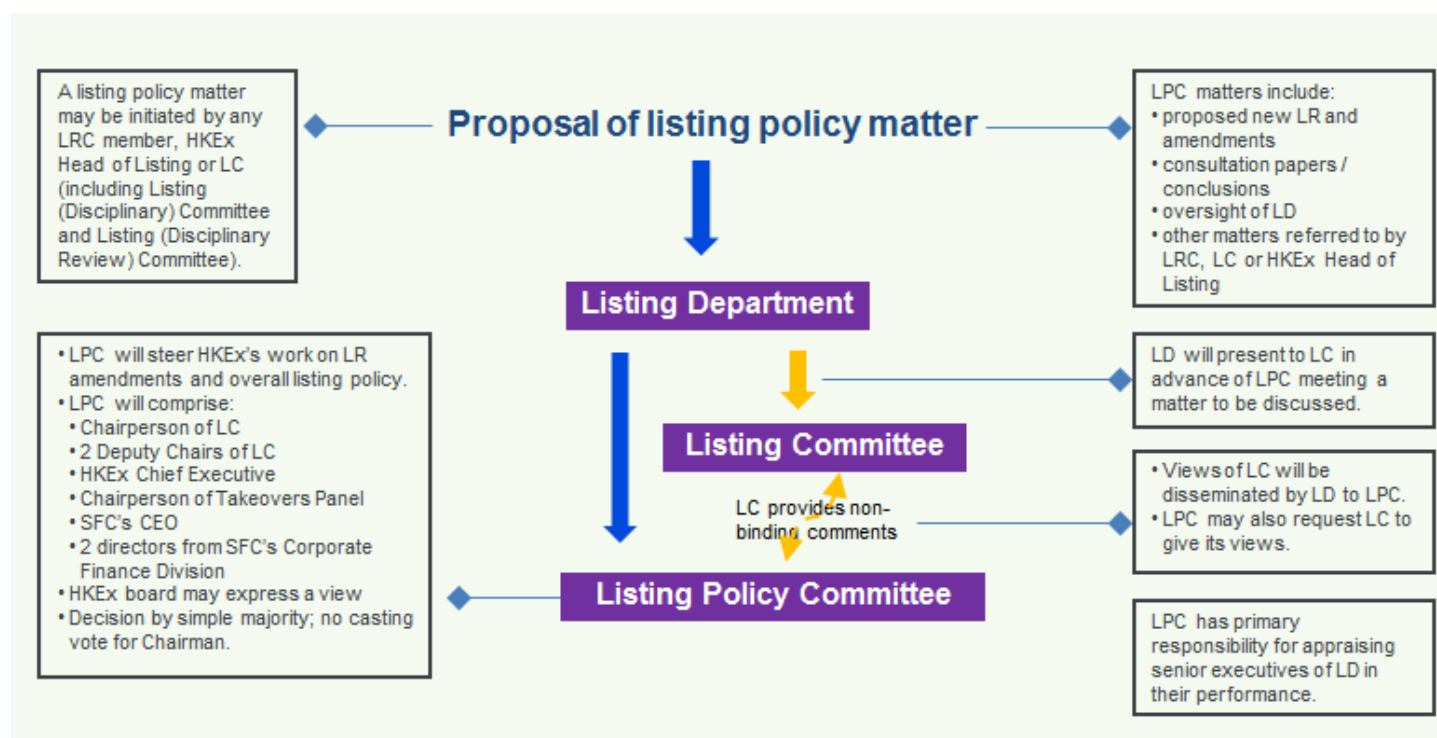
Appendix 2A

The present listing policy formulation process



Appendix 2B

The proposed listing policy formulation process



Note: In addition to the participation through the LPC, SFC will retain approval powers for any proposed major policy changes under the current structure

Appendix 3

Composition of committees envisaged in the consultation paper

Committee	SFC representatives	LC representatives	HKEx representatives
Listing Regulatory Committee* (LRC)	<ul style="list-style-type: none"> Executive Director of Corporate Finance Division# 2 senior Directors of Corporate Finance Division 	<ul style="list-style-type: none"> Chairperson of LC#+ 2 Deputy Chairpersons of LC (including 1 investors' representative+) 	N/A
Listing Policy Committee* (LPC)	<ul style="list-style-type: none"> Chairperson of Takeovers Panel#+ Chief Executive Officer of SFC#+ Executive Director of Corporate Finance Division# 1 senior Director of Corporate Finance Division 	<ul style="list-style-type: none"> Chairperson of LC# 2 Deputy Chairpersons of LC (including 1 investors' representative+) 	Chief Executive of HKEx+
Listing Regulatory (Review) Committee (LRRC)	<ul style="list-style-type: none"> Chairperson of SFC# CEO of SFC# 1 non-executive director of SFC 	<ul style="list-style-type: none"> 3 former members of LC+ (including 1 investors' representative) 	N/A
Listing Disciplinary Chairperson Group (LDCG)	To consist of at least 5 practising or retired senior counsel (or other individuals of equivalent qualification)		
	Nominated by Listing Nominating Committee, appointed by HKEx Board		

* Members of the LPC and LRC shall be appointed by the HKEx Board either as ex officio members or in accordance with the relevant nominations made by the Listing Nominating Committee or the Executive Director of the SFC, as applicable.

Ex officio member

+ Or an alternate where appropriate.

In respect of the LRC, the alternate for each member from LC will (subject to availability and conflicts) be selected by rotation from his or her designated pool of alternates comprising other existing LC members and each alternate for the members from the SFC will be a Senior Director of the Corporate Finance Division or, if none is available, any other Senior Director selected by the Executive Director of the Corporate Finance Division, SFC (or where he or she is conflicted, by the Chief Executive Officer of the SFC).

In respect of the LPC, apart from the alternates specified, other members will not be able to appoint alternates or proxies to act or vote in their absence.

In respect of the LRRC, the Listing Nominating Committee (LNC) shall nominate four additional individuals who formerly served on the LC, including at least one individual who represents the interests of investors, to act as alternates for the LNC-nominated members.

Appendix 4

Section 63 of the Securities and Futures Ordinance:

"(1) It shall be the duty of a recognized exchange controller which is a controller of a recognized exchange company or recognized clearing house to ensure so far as reasonably practicable- (a) an orderly, informed and fair market in securities or futures contracts traded on the stock market or futures market operated by the recognized exchange company or through the facilities of the company; (ab) an orderly, informed and fair market in OTC derivative products traded through the facilities of the recognized exchange company; (Added 6 of 2014 s. 7) (b) that there are orderly, fair and expeditious clearing and settlement arrangements for any transactions in securities, futures contracts or OTC derivative products cleared or settled through the facilities of the recognized clearing house; (Amended 6 of 2014 s. 7) (c) that risks associated with its business and operations are managed prudently; (d) that the recognized exchange company or recognized clearing house (as the case may be) complies with any lawful requirement placed on it under any enactment or rule of law and with any other legal requirement placed on it.

(2) In discharging its duty under subsection (1)(a), (b) or (c), a recognized exchange controller shall- (a) act in the interest of the public, having particular regard to the interest of the investing public; and (b) ensure that the interest of the public prevails where it conflicts with the interest of the recognized exchange controller."