

Hon. Ambrose Lau Hon-chuen, GBS, JP
Chairman,
Financial Affairs Panel,
Legislative Council,
8 Jackson Road
Central
Hong Kong SAR

1st June 2003

Dear Mr Lau,

I am writing to you in connection with the forthcoming meeting of the Financial Affairs Panel on Friday 13th June to discuss the "Expert Group Report". Regrettably, I will be travelling at the time and will be unable to join my colleagues Alan Cameron and Raymond Ch'ien but I would like to make some personal comments in support of their appearance. Since the Panel hearing is only scheduled to last two hours and the issues involved are complex, these comments might serve as relevant background for Panel members and save time on the day.

Since the Expert Group ceased to exist at the end of March 2003, my comments should be taken as those of a private individual whose sole interests as a Hong Kong permanent resident are in the development of Hong Kong as an international financial centre and in the creation of employment in that sector. My own background includes 30 years of experience in the investment banking/securities industry based in North America, Europe and Asia and involvement in various regulatory panels and committees during the past 15 years. Since we appear to be in a period of public consultation and debate I will treat this as an open letter.

You will appreciate that since the Group disbanded, we have had no access to secretariat support nor access to submissions, meeting notes or other records relating to our work so my comments will be based upon the published report, my memory of the process and on personal views relating to events that have occurred since the report was published.

Firstly, we always viewed our work as an independent consultation, the conclusion of which would be a report and recommendations to the Financial Secretary. We recognised that what the Government would do with our recommendations was beyond our control and would obviously be subject to political considerations including the need to respond to those with vested interests to protect.

Nevertheless, we made our recommendations after careful analysis of the views and opinions received from well over 100 respondents across the community, we made our recommendations objectively and unanimously and we did indeed encourage the Government to move quickly and decisively in their implementation. This was because we found during our process broad frustration with multiple consultations and the slow pace of regulatory reform and also because many respondents expressed concern that Hong Kong's position as a serious financial centre was being significantly eroded by this deterioration.

Subsequent allegations that the Financial Secretary acted within hours of receiving the report for the first time are, in my opinion, irresponsible and misleading. During the course of our work, we met with the Financial Secretary and other Government officials at regular intervals to update them on our progress and to inform them of emerging issues. As early as December 2002 it was clear by any rational analysis that

there was overwhelming support for the removal of the listing function from HKEX and strong support for its transfer to the SFC and we said so. The fact that the details of implementation were complex and remain so today cannot alter that conclusion.

It was also clear that there was a demand for decisive action rather than further consultation, delays and prevarication. Government had ample time to consider our findings even though the final report was not submitted until March 2003 and they had ample time to consider their reaction and response. While we had no knowledge of the Government's response until after our report was submitted we were not surprised by their rapid endorsement. I for one believe that the Financial Secretary was seeking to demonstrate decisiveness after careful consideration, to provide strong leadership and to do what is the right thing for Hong Kong's future. It is regrettable that this has been portrayed very differently.

In our report, we say that 'there is an overwhelming consensus that the HKEx should be relieved of its listing responsibilities'. To quantify that level of support, we estimated at various intervals during the period that in excess of 90 percent of the responses received were in favour of making significant changes to the listing regime. As the report also notes, the defenders of the current regime were restricted to a relatively narrow band of parties. As we have seen since however, the small minority, when sufficiently motivated and organised can have a disproportionate impact in terms of media engagement and political influence.

In my view, this will continue to be the case for a number of reasons. Many of the proponents of status quo have a clear vested interest in financial terms. We pointed out that listing fees represent a significant part of HKEx's revenues. They also contribute a significant proportion of profits. This is why, in our report, we stressed that any reform must be 'bottom-line neutral' to HKEx since it is clear that their regulatory function had become a significant contributor to profitability. Similarly, many of the smaller financial intermediaries consider themselves to be beneficiaries of the current system and not surprisingly some listed companies can see the benefits of less than effective corporate regulation.

Of those in favour of reform, many are investors and many of those invest in markets globally of which Hong Kong represents a relatively small part. As we pointed out in our report, their interest is mostly confined to a relatively small universe of listed companies in Hong Kong and an even smaller number of recent new issues. They are in general not organised as a lobby group and have little incentive individually to invest time and effort in media engagement and political manoeuvring. They have better things to do with their time. They have many investment alternatives and where they lack confidence, they will either vote with their feet or discount the prices they will pay for securities, increasing the cost of capital for Hong Kong-listed companies. The markets and regulatory environments where they have the most confidence will be the beneficiaries in the long term.

Other market participants, intermediaries, listed companies and other respondents who supported reform to us privately are in many cases unable or unwilling to express their views publicly, certainly not as publicly as HKEx has done. This is regrettable but understandable given concerns about business relationships, fear of offending vested interests and in some cases a long-standing frustration with inaction and a resigned view that 'nothing will ever change'.

Accordingly, any public consultation conducted through the media will never give a fair picture of true sentiment.

If I could make some brief, personal comments on what has occurred since our report was published, I should start by saying that I was disappointed but not surprised by the unfortunate behaviour of certain officials of HKEx which has been very damaging to Hong Kong's international reputation. Following the Government's endorsement of our proposals I noted the HKEx official response which expressed disappointment but confirmed that HKEx would work closely with the Government and the SFC in the implementation of the recommendations.

I believe that many observers both locally and in the international community were shocked by the subsequent revocation of that commitment, particularly by an institution where integrity and trust is fundamental to its reputation and credibility. Similarly, the letter to the Financial Secretary and the subsequent media barrage have cast an unseemly light on this whole discussion. The subsequent reappointment of certain HKEx public interest directors who had vocally opposed Government policy and threatened to resign has raised further issues.

These events have brought into question the very nature of the relationship between the Government and a commercial entity to which it has granted monopoly powers. Indeed, given the Government's swift capitulation to pressure from certain vested interests and its decision to conduct further consultation and delay implementation, serious questions have been raised in the international community about governance at the most senior levels in Hong Kong.

If I could move on to the letter from HKEx to the Financial Secretary dated 1st April 2003, perhaps some background is in order. It became clear to us shortly after our project began in September 2002 that HKEx had engaged a number of external consultants to assist them in preparing their various submissions to the Group. Given the lack of involvement of the HKEx Board as a whole in this area, necessitated by conflict of interests considerations, in the matter of listing regulation at least, HKEx had, in effect, outsourced its strategy. This was in contrast to other respondents who chose to write their own submissions from their own resources. Since this relationship was never acknowledged by HKEx, we did not have the opportunity to meet in formal circumstances with the consultants who had helped prepare the HKEx submissions.

In the interests of completeness however, I should say that I did meet informally with two of the consultants on separate occasions. In these circumstances, where there was no official acknowledgement by HKEx of the consultants' role, it will be appreciated that continuing dialogue with HKEx officials on points of detail was difficult and often unhelpful. It should also be said that this process led to considerable delays and extensions of deadlines. HKEx's first submission was received some time after the official closing date for submissions respected by others while their final submission was received when our report was in the final stages of preparation.

We assume that the HKEx letter to the Financial Secretary was crafted by the same consultants since there was little of substance or style in the letter that differed from the submissions received from HKEx. As to the letter and subsequent press coverage, it is too long to address every point in detail and I am sure that my colleagues can respond to specific issues at the Panel hearing.

However, perhaps I could make some general observations since to my knowledge, the letter has heretofore gone unanswered.

1. All HKEx submissions were considered and discussed in great detail by the Group and were absolutely given a fair hearing despite the fact that, as

mentioned earlier, they were consistently late. An overriding principle of our work was confidentiality and as mentioned on the second page of our report, we did not attribute specific opinions or proposals except in cases where the respondent approved our doing so. This was an important commitment to the great majority of respondents who sought such assurances. This does not mean that we did not consider each submission in detail. In the case of HKEx, we did seek approval to attribute and discuss the separate subsidiary proposal which we did at least consider worthy of open discussion. As the letter points out, this is discussed in the report but our clear conclusion was that it in no way resolved the conflict of interests issues, would still leave the Listing Rules with no teeth and would increase the duplication of roles and the use of part-time volunteers.

2. The report contains detailed discussion of the whole issue of conflict of interests and I do not intend to repeat them here. Suffice to say that of all the respondents, HKEx was about the only one that argued that this conflict did not exist or that it was only a matter of perception. Even in the letter itself 'grave concern' is expressed about the financial implications of the proposed transfer, a demonstration of the conflict in itself. As mentioned previously, the Group fully recognised that regulation has become a very profitable business and in the interests of a smooth transfer, those profits should be left with HKEx but in the interests of the overall market, regulation should be put where it belongs - in an independent entity with statutory powers.
3. The notion that our recommendations would be damaging to the economy and undermine HKEx' competitiveness is, in my opinion, simply misguided. Anything which improves the quality of Hong Kong's market structure and brings it closer to best practice can only be positive for Hong Kong. With regard to the argument that HKEx would be weakened competitively in the quest for new listings from China, we need to be honest with ourselves. China's leading companies will of course always be targets of the world's leading exchanges, primarily New York and London, but will always need an exchange in their own time zone. Indeed, in the introduction to our report we recognise that HKEx 'during the past decade, has established itself as the venue of choice for leading Mainland enterprises wishing to tap the international capital markets'. HKEx' pioneering work in establishing the 'H' share market in the early 1990s is a great credit to its leadership. However, further down the scale in terms of size and quality there is much less enthusiasm from the major international markets and it is clear that markets such as Singapore are not prepared to compromise their standards simply to encourage listings. It is equally clear that many of these companies listing in Hong Kong could not list on the Mainland markets, or at least not for a considerable period of time. Put simply, some of these companies have nowhere else to go.

In any event, low quality repels investors. If Hong Kong loses some listings to other markets because those companies cannot meet our standards, then this will be to Hong Kong's benefit and our competitors' detriment.

For all of these reasons, the suggestion that our recommendations may jeopardise Hong Kong's role as a capital raising centre for China is

misinformation. A more efficient and effective regulatory environment would only enhance that role.

4. Much is said in the letter and in the press about checks and balances and the centralisation of powers and this is a genuine concern to which we gave careful consideration. However, checks and balances are required in any organisation. At HKEx for example, it is very clear that the part-time Listing Committee cannot and does not supervise the listing division and therefore carry out its supposedly delegated functions. Our report pointed out that members of the Listing Committee have not felt authorised or empowered to oversee the activities of the listing division. It is notable, but not widely appreciated that the new Memorandum of Understanding Governing Listing Matters between the SFC and the Stock Exchange of Hong Kong, dated 28th January 2003 includes no reference to this responsibility, in contrast to the previous MOU dated 6th March 2000 where the responsibility was quite specific. The Listing Committee has understandably refused to be accountable for something it cannot control and there is no longer any pretence of supervision. It is equally clear that the listing division operates independently of the HKEx Board as a result of conflict of interests issues. In practice also, the SFC currently has a limited supervisory role. So it could be said that a great majority of the regulatory and disciplinary function at HKEx currently operates with little check and balance at all, particularly in light of the new MOU.

In the case of the SFC, while there is a natural concern about the centralisation of powers, it seems to me that there are many checks and balances in place. To begin with the SFC submits its budget to Legco and the Government has oversight in its policy role. Then there are the Commission's non-executive directors, the proposed Listing Panel on policy and appeal matters, the Process Review Panel, the SFC Advisory Committee and the SFC's Shareholders' Group as well as the Securities and Futures Appeal Tribunal which is chaired by a judge.

The proposed Hong Kong Listing Authority would operate as part of a fully accountable statutory body free of any perception of conflict of interests and further checks and balances could be implemented if deemed necessary.

5. The report's suggestion that insufficient resources have been dedicated to enforcement by HKEx is rebutted in the letter by reference to the fact that executive staff headcount during the past three years has grown from 68 to 89 in the listing division. Our understanding is that less than a handful of these staff are engaged full time in enforcement and disciplinary matters and that the number of cases dealt with is insignificant. In 2002 for example, disciplinary measures amounted to 6 public censures (5 of which were for late publication of accounts), 1 public criticism and 7 private reprimands. The great majority of staff in the listing division are involved in prospectus vetting and the vetting of ongoing company announcements.
6. In discussing the possible transfer of regulatory responsibility, the letter states that 'HKEx may be happy to be relieved of this involvement, but whether this

will be in the overall interests of Hong Kong is a matter which needs careful consideration'. This apparent happiness has not been visible in the subsequent press campaign. It goes on to imply that the transfer would result in a 'merit-based' regulatory system in place of the 'disclosure-based' approach and could suggest that HKEx is providing some sort of 'quality assurance'. The apparent distinction between the two systems is sometimes misconceived. Exercising judgement does not imply that any assurances are given. Rather, it should mean knowing when and where to require more disclosure, how to examine that disclosure effectively and when not to accept extensive disclosure which is still misleading or places form over substance.

There are other aspects of the letter which are worthy of response so my comments are not meant to be exhaustive. As mentioned earlier I am sure my two colleagues can address detailed questions directly with the Panel.

Several weeks ago in Legco, the people of Hong Kong were told by the Chief Executive 'Change with the times because the times are changing. If you don't embrace this new era time will give up on you and dump you.' These are prophetic words. They are also very pertinent to this discussion. Financial markets globally are in a period of dramatic reform in terms of regulatory practices and corporate governance. Hong Kong can either embrace this global trend and identify itself as a leader or it can drag its feet and resist change in the interests of a small minority. We have taken the latter route before in a number of areas.

I sincerely hope that the Panel's discussions can help lead this debate toward a swift resolution which will reposition Hong Kong as a leader in market reform and best practice and not a parochial provincial city placing the short-term interests of the few above the long-term interests of the many.

Yours sincerely,

Peter Clarke