31 October 2002

Clerk to Panel on Financial Affairs
Legislative Council Secretariat
3/F Citibank Tower
3 Garden Road
Central, Hong Kong

Dear Sir/Madam

Views on the Report of the Panel of Inquiry on Penny Stocks Incident

I refer to your invitation to members of the public and interested organizations to express views on the Report of the *Panel of Inquiry on Penny Stocks Incident*.

The Consumer Council has made the attached submission to the Expert Group to Review the Operation of the Securities and Futures Market Regulatory Structure.

The Council's submission to the Expert Group relates to issues that also arise in the context of the LegCo Panel on Financial Affairs' interest in the 'Penny Stocks Incident'. I am therefore forwarding a copy of the Council's submission to the Panel for their consideration.

Yours sincerely,

Mrs. CHAN WONG Shui
Chief Executive

encl.

CONSUMER COUNCIL

SUBMISSION TO THE EXPERT GROUP TO REVIEW THE OPERATION OF THE SECURITIES AND FUTURES MARKET REGULATORY STRUCTURE

1. The Council welcomes this opportunity to provide comments on the review of the operation of the securities and futures market regulatory structure.

2. The Council notes that in conducting the review, the Expert Group is required to have regard to a number of issues, including the need to maintain the status of Hong Kong as an international financial centre; the competitiveness of Hong Kong as a centre for listing companies; and the diversity of issuer and investor bases of the Hong Kong securities and futures market.

3. The terms of reference encompass a wide range of concerns. Being a consumer advocate, the Council's comments in this submission are largely directed at issues of specific relevance to retail investors.

Costs and Benefits

4. Before making any changes to the current regulatory structure, the government should undertake a cost/benefit analysis regarding the proposed changes. In particular, identify the benefits to Hong Kong and also the costs to all the stakeholders if the proposed changes are implemented. Stakeholders would include not only the regulators, but also retail investors, issuers and market practitioners.

Public Duty

5. From what has been proposed recently, it appears to the Council that the Government and HKEx are in favour of de-listing a corporation from the Stock Exchange rather than facilitating the rescue of companies in financial difficulties. The stringency and inflexibility of such a course of action goes against the judicial trends in corporate rescue (both internationally and in Hong Kong) which are more supportive and amenable to giving companies a new lease of life and at the same time averting loss suffered by retail investors. It is not uncommon for corporate rescue to take 12 to 24 months to complete. Any measures taken against corporations that are facing difficulties should recognise the need to give them adequate time to attempt a resolution to their problems.

6. HKEx should investigate in the first instance why problems with a company's share price have occurred in the first place. For example, the underlying reason for the company's non-performance which differed from the company's pledge that formed part of HKEx's decision to list the company in the first place, or problems with corporate governance and whether action can be taken against the company based on findings of the investigation.

7. HKEx currently enjoys a monopoly status in Hong Kong. It is arguable therefore, that in view of the monopoly endowments it and its members possess, that it has a public duty to look after the interests of smaller capitalisation companies as well as those of the retail investors. An analogy

can be drawn to the universal service obligations that other monopoly service providers, such as utilities, are compelled to observe.

8. The delisting of corporations ignores the plight of retail investors who get caught with shares in those corporations and are left with investments that they are unable to trade. Effort should be made to examine alternatives to delisting, and find appropriate mechanisms that will provide retail investors with the means to trade the shares rather than merely resorting to delisting. Two possible mechanisms, such as alternative listing, or consolidation are examined further in this submission.

Timing of major changes

9. In light of the current unprecedented economic downturn in Hong Kong, the Government should consider whether now is an appropriate time to introduce, or to even discuss the introduction of significant changes to listing rules.

10. The companies that listed shares on HKEx, and the retail investors who bought shares on the Stock Exchange, did so on the basis of existing listing rules. It is arguable therefore, that they have a legitimate expectation that no dramatic change or paradigm shift in the 'rules of the game' (such as the cancellation of listing status and the introduction of a continuous listing eligibility criteria) will take place.

Listing of Shares

11. With regard to the specific issue of listing, and the recent proposals that gave rise to the 'Panel of Inquiry on the Penny Stocks Incident', this centres around two main issues:

a) The creation of a set of benchmarks for continued listing on the HKEx; and

b) What should be done to stocks that fall below the benchmark level.

Listing benchmarks

12. From a small retail investor's point of view, the initial listing requirements set by the HKEx and the ongoing reporting requirements should be the primary concern.

13. To allow de-listing, or make it easy to accomplish, is to diminish the importance of listing on the exchange, and weakens the sense that the HKEx will exercise due diligence in allowing listing in the first place.

14. Once a share price has reached a certain level, then investors will form their own opinions as to the worth of the shares. This will vary and depend on the economic sector in which the corporation operates, and the economic variables that affect that sector. These will be different depending on each sector of the economy.

15. If a benchmark is to be set, it should be to indicate at what point there is a concern by the HKEx that the views it formed as to the viability of the

corporation, that gave rise to HKEx listing in the first place, have been lowered and that some remedial action is required.

16. There are two options as to what happens when a stock falls to that level:

a) consolidation; and

b) alternative listing

Consolidation of shares

17. Consolidation of shares would provide a short term relief for investors. The higher the threshold for consolidation, the better the result for investors because the higher share price might reflect more favourable trading spread terms.

18. However, consolidation would not seem to provide a long term resolution of the problems the corporation is facing that led to the fall in share price.

Alternative listing

19. With regard to alternative listing, the difficult question is what sort of alternative rules should apply to those that apply with primary listing.

20. Taking the view that due diligence should have been exercised in allowing listing in the first place, the requirements, insofar as financial reporting and corporate disclosure are concerned, should be set with a view to imposing a higher discipline on the corporation than would apply if the share price is above the benchmark. If lower reporting requirements are imposed, then this would only seem to exacerbate the eventual decline of the share price. Moreover, the creation of an alternative listing on this lower reporting basis could give the impression that corporations on that list have been abandoned.

21. Nevertheless, the problem of falling share prices for some shares could have more to do with sector problems that have little to do with corporate governance. For example rising energy prices for a corporation that is highly susceptible to the cost of energy, or the introduction of substitutable competing technologies or services that have undermined the corporation's long term prospects.

22. Given the difficulty in setting rules for alternative listing, consolidation would seem to be the simpler means of providing investors with some relief.

'Grandfather' listings

23. A further alternative approach would be for the HKEx to grandfather the shareholding of a corporation which has already been listed prior to the introduction of the new benchmark level, for continued listing on the Hong Kong Stock Exchange. In other words, the new benchmark de-listing or consolidation level would only apply to a corporation listed after the date on which the new benchmark becomes effective. This approach would recognize the principle of legitimate expectation raised in paragraph 10 above.

Regulatory Structure

24. The terms of reference include a reference to reviewing the lines of communication between the Government, the SFC and the HKEx. The

recent report into the 'Penny Stocks Incident' noted that the lines of communication between the three could be improved. There are two approaches that can be taken in this regard:

a) a review of the rules and procedures used, particularly the regulatory procedures adopted by HKEx; and

b) separation of regulatory functions.

Principles of self regulation

25. The HKEx is essentially an industry association being vested with a self regulatory function, comprised of competing market participants. One way of approaching perceived problems with the manner in which HKEx is operated is to ensure that it follows 'best practice' principles of self regulation. In the United Kingdom where self regulatory schemes are common, the schemes:

a) are backed up by strong legislation and a well resourced regulator; and

b) are sufficiently independent to avoid conflict of interest and undue influence by the trade, in that staff who administer the schemes are not directly controlled by particular members of the subject industry (e.g. funding of the schemes takes place through levies paid by members to trust funds which employ staff).

26. In recent years the concept of 'co-regulation' between the industry scheme and the government through relevant regulatory authorities, has also emerged. The Council has not examined the nature of the current two-tier (self) regulatory mechanisms, i.e., sharing of regulatory responsibilities in the operation of the HKEx and SFC. The Council would only urge that self regulatory principles along the lines outlined above play a part in monitoring the HKEx, particularly given its monopoly position.

Improving the Quality of the Market

27. The objective in examining the issues listed in the terms of reference is to improve the quality of the market and also boost investor confidence in the market. The current quality of the market in Hong Kong is to a large extent attributable to the unprecedented economic downturn in Hong Kong. In this current climate, a better approach would be to improve the quality of the market and boost investor's confidence in the market through educating market players and listed issuers on the importance of corporate governance and the introduction and enforcement of effective corporate governance regulations.

Consumer Council
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