



HKSI Institute Roundtable Luncheon Series

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Last summer the Securities and Futures Commission (SFC) and The Stock Exchange of Hong Kong Limited (the Exchange) issued a joint consultation to do with the way in which listed companies might be regulated in future. The underlying issue was whether the current system, where the Exchange and the SFC both have a role, is delivering the best results for the public and the market and, if not, what could be done to improve things.

The consultation ended in November, but generated a public debate that was sometimes quite heated. Around 8000 submissions were sent in, and some groups even appointed PR firms to help influence opinion, mainly against any change.

At one extreme, some of those opposed to any changes to the current system were of the view that the proposals were an SFC “power grab” of the Exchange’s job as regulator under its Listing Rules. There were also views that listed companies should be listed under a “pure” disclosure system, and that it was for the SFC to detect and eliminate any subsequent problems. This camp felt that implementation of the proposals would lead to chronic over-regulation by the SFC, which would choke off any chance of meaningful market development.

At the other end, some of those supportive of change felt that all listing regulation should move across to the SFC. They believed that the existing system of shared regulation is inefficient and ineffective and Hong Kong is out of step with international norms. They also felt that the Exchange has an irreconcilable conflict between its role as a regulator and as a commercially driven organi



So today I want to spend most of the time talking about this new approach, and then touch very briefly on the New Board.

From the outset I should say that last summer's joint consultation paper did make at least one major omission. This was pointed out by quite a few respondents and commentators across the spectrum of opinion.

The missing bit was that nothing much was said about any specific problems in Hong Kong's listed market which would suggest that making major changes to the way in which we regulate would be worth the effort.

So I think I should clarify the SFC's view on this.

Over the last few years we have in fact repeatedly pointed out areas of concern, mainly centred on too many instances of misconduct. We have an ever-expanding enforcement caseload to do with what can be loosely grouped under a heading of listed company accounting fraud, together with different forms of market manipulation. Manipulation is a particular problem in smaller listed companies with minimal public floats – but not exclusively so.

And a good illustration of some of the more complex issues we face was the recent “crash” in the shares of a network of smaller interconnected listed companies and brokers. This type of incident raises a whole host of issues about financial markets activity wholly detached from corporate fundamentals, as well as about corporate governance and very poor overall outcomes for public investors.

On top of this, increased connectivity and two-way capital flows between Hong Kong and the Mainland mean that comprehensive enforcement and supervisory cooperation between the SFC and the China Securities Regulatory Commission is now a top priority for both organisations. This is because investors in each of our markets are increasingly exposed to risks in the other market. And on top of that those intent on misconduct can operate from the other jurisdiction.

So in short we think that these types of problem certainly justify a real effort to find ways to regulate more effectively.

Of course tackling misconduct through traditional enforcement is always vital to send strong deterrent messages to companies, initial public offering (IPO) sponsors and other intermediaries.

But we were convinced there was still a gap in regulation.

This was really centred on questions about the way in which the Exchange's Listing Rules operate alongside the SFC's own role in listing regulation, especially when it comes to gatekeeping. Gatekeeping is about whether companies are fit to join public markets as well as the regulation of mooted transactions by companies that are already listed.



The Exchange's "red book" is positioned as the main set of rules governing listed companies. And the Exchange is the front line regulator of listed companies under these rules. By and large, outside its enforcement remit, the convention under the dual filing system has been for the SFC to take a back-seat in IPO and other types of gatekeeping, acting pretty much behind the scenes.

And many responses to the joint consultation pointed out that something was missing in the proposals quite apart from not highlighting market problems justifying reform. This was that in pursuing a revamp centred on a far more collaborative gatekeeping effort between the SFC and the Exchange under the Listing Rules – which was to be achieved through the joint committee structure – we could have been ignoring some better alternatives.

These alternatives were to do with the SFC's own functions as the statutory market regulator, as distinct from the Exchange's role in administering its own non-statutory Listing Rules.

Some market practitioners felt that the proposals should have focused much more on how the SFC's powers could be used in different ways to gatekeep and intervene in our markets more proactively. This implied a change in the long standing convention whereby the SFC defers to the Exchange as front-line regulator and single point of contact in all listing matters. And it was about how best to use existing legal powers in today's markets to avoid harm arising in the first place and, as a result, protect the reputation of Hong Kong as a leading financial centre.

And I think we can all agree that reputational damage to the overall market can be very

look at the local and international press coverage of the extreme volatility of the interconnected small cap stocks I referred to earlier to see how true this is.

In light of this, and again governance and miscellaneous

conduct issues, we decided to have a fund

We looked at the issue from a different angle, making a big effort across our operating divisions to re-examine all of the existing regulatory tools at our disposal. We looked at how the different parts of the system worked together and how they could be improved. We looked at the whole listed company lifecycle.

And when by the end of last year we had decided on a way forward we then started to implement our new approach for real. Now we have a few years of experience of this new way of doing things.

Some of this is already apparent to the public from more recent decisions, guidance and press releases. I'll get into some of the detail later on.

But before I start dealing with the nuts and bolts I want to put our new approach to listing regulation in the context of some broader changes across all of the regulatory work at the SFC.



Of course our overarching goal remains unchanged, which is to pursue a sound regulatory basis for the future and to help ensure that Hong Kong stays competitive as a leading international financial centre. That should be obvious.

But, what we are now aiming for is regulation which is far more “front-loaded”, to get ahead of the issues.

This means placing far greater emphasis on earlier, more targeted intervention. It means delivering fast and responsive regulation and maximising the impact of our actions. And it also means focusing on the greatest threats, or the most significant or systemic risks.

So we have changed how we organise ourselves to be more specialised, collaborative and multi-disciplinary, making much better use of our resources.

This is especially the case for the Enforcement Division, where the workload was threatening to overwhelm. Our Intermediaries Division has also shifted to an emphasis on thematic reviews of licensed firms, signalling publicly and well in advance the areas of risk we will follow up on in firm-by-firm supervisory inspections.

We have also set up special operational teams drawn from different divisions to take on the more serious market problems.

One of these, codenamed “ICE”, is of special relevance to listed companies. It pools resources from our Intermediaries, Corporate Finance and Enforcement divisions in a concerted effort to tackle all of the harder issues, from gatekeeping to the conduct of licensed firms who interact with listed companies through to enforcement. This has already proved to be a very powerful tool.

Now I have mentioned that the joint consultation didn’t talk about the market problems that the proposals could be solving, but that the SFC has in fact on many occasions highlighted areas of concern. So I make no apology for repeating some of them now.

We have seen just too many companies with inexplicably inflated valuations as a result of unusually sharp share price increases. This has happened on both the Growth Enterprise Market (GEM) and the Main Board. The same is true of the derivatives market.



I should say here that the issues I've described certainly do not pervade the entire market. But they are sufficiently serious that it would be wrong of me to try to sugar-coat the challenges we face.

As I've mentioned, these trends led to a big increase in our enforcement workload.

Inquiries into corporate governance or disclosure issues, insider dealing and market manipulation have more than doubled since 2011, and the number of formal disciplinary and other proceedings have increased by more than 50%.

While enforcement is a vital aspect of market regulation, many enforcement actions



We also took action in relation to an existing listed company's proposal to issue shares to a small group of subscribers at a price very significantly lower than the market price. The subscribers would have then ended up with over two-thirds of the company's shares with minimal outlay.

The company did not appear to have any actual funding need, and it failed to explain why the placing was being conducted on this highly dilutive basis. After we informed the company that we intended to object under the SMLR, the placing was terminated.

We have also acted under the SMLR to suspend trading in seven stocks this year. Most suspensions can be seen as a type of exceptional early protective action, usually done during an investigation which in itself may ultimately lead to sanctions and other legal action. Companies can always appeal to our Board for a resumption of trading, as one did earlier this year.

In another suspension case, a company had pursued many highly dilutive capital-raising exercises within a very short time, but again seemed to lack any need to raise new funds. An investigation found that directors of the company had hidden connections with some of the shareholders who voted to approve the fundraising as well as with others who had acquired shares from the underwriters.

We concluded that the company's announcements might have been false because they did not disclose these connections, and that these share issues could not be in the interests of public shareholders. We decided to suspend trading as a necessary investor protection measure.



If we do issue a letter of mindedness to object under the SMLR, the Exchange would have the discretion to continue or suspend its own listing process regardless of whether our concerns have been addressed. We will always do our best to work within the Exchange's timetable.

I should also say that our aim is to make our concerns known to a listing applicant – with detailed reasons – as early as possible after an IPO application is filed. This is to enable bilateral discussions to start very quickly, again contributing to a more efficient process.

One other consequence of these changes is that “suitability” for listing will continue to be decided on by the Exchange. Suitability is a concept that only appears in the Exchange's Listing Rules, and not in the SMLR.

This means that it would theoretically be open to the Exchange to reject an IPO as being unsuitable even if the SFC has not identified grounds for objection under the SMLR. However, we expect that the basis on which the SFC would object to an IPO would in practice have raised suitability concerns if a listing had reached that stage.

And finally, because the SFC will no longer comment on IPOs that don't give rise to concerns under the SMLR, we intend to supervise the regulation of these listing applications through an enhanced, published audit or review of the Exchange's listing regulation work. We will make sure our audit or review is thorough, fair and constructive.

So much for IPOs. What about our approach after a company is listed? Again we are placing greater emphasis on targeted, early intervention. This is particularly important where there is a need to tackle illegal or improper practices.

Consistent with the approach taken for IPOs, if we intend to object to a listing application under the SMLR – such as for a follow-on equity offering – we will normally issue a letter of mindedness with our reasoning set out in full. SFC staff will then make themselves available for discussion with the company and its advisers. Again any final decision will be appealable.

Where possible, we will follow a similar approach if we intend to suspend trading under the SMLR – a letter will normally be issued asking the company to explain why a s0



The average size of IPOs has declined dramatically over the last 10 years, as has the trading volume in newly listed stocks. None of the companies listed in the last five years have joined the Hang Seng Index and many of the larger ones are in sectors such as real estate or finance. And the very largest listed companies now account for about 90% of market capitalisation and trading, which is dominated by institutional investors.

And although smaller companies are the fastest growing segment – now representing about 80% of all listed companies – they account for only a very small part of total market capitalisation and turnover. And most of them operate in sectors which are far from “new economy”.

So when thinking about market structure I believe that we need to step back and look carefully at two basic issues.

First, how to grow the top tier of our market to continue to attract the international capital that is vital to maintain Hong Kong’s status as a leading stock market. We need to broaden the universe of large listed companies with businesses of interest to global investors, where deep and liquid trading is concentrated.

Second, although the overall supply of new listings is very strong, these are small companies, often with old economy businesses, and are likely to continue to arrive in large numbers. But the demand for these companies is not institutional; it only rests on a small pool of retail and non-institutional professional investors. The result is a market increasingly saturated by small-

