Response of the Securities and Futures Commission to the Government' s Consultation Paper on Proposals to Enhance the Regulation of Listing

January 2004

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Executive Summary

Background

1. This paper is the SFC's response to the Financial Services and the Treasury Bureau's Consultation Paper on Proposals to Enhance the Regulation of Listing ("Consultation Paper"). The Consultation Paper centres on proposals for:

   - statutory backing to HKEx's Listing Rules; and
   - alternative models for a new regulatory structure.

2. The Consultation Paper followed the Report of the Expert Group to Review the Operations of the Securities and Futures Market Regulatory Structure ("Expert Group") in March 2003.

3. Hong Kong's future as an international financial centre depends on its role as the premier capital formation centre of China. One of its principal attractions is the ability for the public and institutions to invest in Hong Kong and Mainland China enterprises in an advanced regulatory environment. This advantage is crucial to Hong Kong's competitiveness and it is vital that Hong Kong maintains a regulatory system that is comparable with leading international markets.

4. This response is founded on a consensus view about the need for reform. The approach taken by the SFC is to propose a pragmatic, feasible and detailed blueprint for reform to improve the quality of the market and to ensure that Hong Kong's system of listing regulation matches international financial centre standards.

Consensus

5. The SFC's proposals take into account and build on the work of the Expert Group, the views of the Standing Committee on Company Law Reform ("SCCLR") and HKEx, as well as the dominant views of the market and media. There is a consensus about the fundamental direction of reform, which is:-

   - to upgrade market quality by improving the regulation of listing;
   - to build on the Dual Filing regime to give statutory effect to the Listing Rules, recognising the current limitations of Dual Filing;
   - to adopt a North American model for listed company regulation, where there is a statutory regulator of corporate disclosure; and

- to ensure that there is a clear division of work for the shared regulation of listed companies, to be delineated along statutory and non-statutory lines.

6. The SFC agrees with the Consultation Paper:-

- that it would be beneficial to Hong Kong's market development to follow the example of jurisdictions such as the United States, United Kingdom, Australia and Mainland China to regulate listed companies through statutorily backed rules (para. 5, Executive Summary);

- that *"Promoting compliance and facilitating enforcement in this manner should help enhance market quality thus attracting issuers and investors to our market*" (para. 6, Executive Summary); and

- that "*Clearly, as a for-profit commercial entity and a listed company, SEHK would have some difficulty administering statutory listing requirements …*" and "*most, if not all, statutory listing requirements would have to be administered by a statutory regulator …*" whilst SEHK "*should have ultimate control over which companies should be listed on its trading platform as this is essential to establishing and maintaining its "badge of quality""*" (para. 10, Executive Summary).

Basis of the SFC Reform Proposals

7. The general approach of the SFC is to propose a pragmatic, feasible and technical solution that will ensure that Hong Kong's system of listing regulation matches international financial centre standards.

8. The SFC's proposals will operate within the existing Securities and Futures Ordinance ("SFO") framework and will be capable of being administered flexibly to meet evolving market development and investor protection needs. They will preserve and, where appropriate, strengthen the existing checks and balances contained in the "three tier" regulatory system.

9. The proposals involve:

- The introduction of all the detailed disclosure obligations in the Listing Rules, together with the Listing Rules governing significant and connected transactions, into existing subsidiary legislation under the SFO;

- The clarification of SFC responsibility, as statutory regulator of listed company disclosure (which has already begun under Dual Filing), for the administration of the new statutory rules;

- Effective sanctions for breaches of the new statutory rules including civil fines and disqualification orders;

- Flexibility in the SFC's administration of the new statutory rules by waivers, modifications, or class exemptions, including publication of guidelines to inform the market about the detailed operation of the new rules;

- Full-merits appeals to the existing Securities and Futures Appeals Tribunal ("SFAT") from all decisions under the new statutory rules;

- Extensive safeguards over the imposition of regulatory sanctions for breaches of the new statutory rules – options include referrals of cases for decision to an expanded Market Misconduct Tribunal ("MMT") dedicated to hearing such matters and the expansion of the types of market misconduct in the SFO to include breaches of the new statutory rules;

- A committee of market participants established under the SFO to advise the SFC;

- Clarification of the application of the Companies Ordinance to avoid duplicative disclosure requirements for companies applying for listing;

- Introduction of a statutory public electronic database to ensure transparency for all statutory disclosure documents;

- More effective regulation of sponsors; and

- Enhanced cross-border regulatory co-operation.

10. **The SFC considers the proposals in this paper will upgrade the regulatory structure for listed companies to assure Hong Kong's long term future as an international financial centre. Implementation will result in clear benefits for investors, listed companies and intermediaries. The SFC also believes that reform should not be delayed.**

Benefits of the SFC Reform Proposals

Statutory backing allows effective enforcement

11. **Reform will give statutory force to crucial Listing Rules** which mandate listed companies to disclose financial and other information to the market at and following IPO ("disclosure rules"), together with those rules which require significant and connected transactions to be disclosed and, in some cases, put to shareholders for approval ("transactions rules"). Breaches will lead to civil sanctions, including fines and directors' disqualification orders and the SFC's investigatory powers can be brought to bear. A high civil

standard of proof (a high degree of probability) will apply. Civil sanctions are important for the effective enforcement of market rules.

Clarity of roles and responsibility of regulators

12. **Reform will identify clearly the roles and responsibilities of the SFC, on the one hand, and HKEx, on the other.** A patchwork of listed company regulation is currently shared between the two regulators, and this has resulted in concerns about responsibility and accountability. This also compromises regulatory effectiveness. In the reformed system:

- The SFC, as statutory regulator under the SFO, will administer and enforce detailed disclosure and transactions rules transferred from the Listing Rules into subsidiary legislation under the SFO.

- HKEx will continue to be the front-line regulator of non-statutory rules i.e. all the current Listing Rules minus the disclosure and transactions rules. It will be responsible for the quantitative criteria which companies have to meet to list on its markets (track record, expected market capitalisation, minimum public float, spread of shareholders etc), set exit criteria and promulgate non-statutory conduct rules and codes, including those regulating corporate governance. It will also continue to supervise market operations and regulate exchange participants through its trading and clearing rules.

13. **Reform will adopt a North American model.** The new statutory rules will mandate all corporate statutory disclosure documents to be publicly filed in a central electronic database. This will be similar to the "EDGAR" public filing system in the United States, and will facilitate transparency for all investors. The overall division of work will also follow closely the model in the United States, where the SEC has principal responsibility for reviewing corporate registration statements which provide prospectus-level disclosure. Similarly, the SFC, as statutory regulator, will seek to ensure compliance with statutory requirements which are generally disclosure related. Once the SFC clears a statutory filing HKEx, like the NYSE and NASDAQ, will still have control over the admission of companies to its markets in accordance with its own entry criteria.

HKEx's conflict of interest reduced

14. The area in which HKEx will have **a perceived "profits versus regulation" conflict of interest will reduce substantially** once disclosure and transactions rules are administered by the statutory regulator under the SFO framework.

Market to function free from undue regulatory interference

15. An inability to impose credible sanctions on those who breach the Listing Rules has contributed to a concentration of regulatory effort on detailed pre-vetting of disclosure documents, with little emphasis on enforcement. This has led to a misallocation of responsibility and resources between HKEx and

the market and frequent suspensions of trading pending clearance of announcements by the Listing Division.

16. **Reform will enable the market to function free from undue regulatory interference, but subject to credible sanctions for breaches of statutory disclosure and transactions rules**. Companies and their financial advisers will be expected to take appropriate responsibility for accurate announcements, circulars and other disclosure documents**.** Rather than micromanaging the drafting of prospectuses and other corporate disclosure, the regulatory emphasis will shift from front-end vetting to back-end statutory enforcement under the SFO to deter substandard work.

The New Legislative Framework

New Rules under the SFO

17. **The new statutory regime will be comprehensive, effective, and adaptable to changing market conditions.** The SFC's blueprint for reform centres on the introduction of the disclosure and transactions rules into subsidiary legislation through an expansion of the existing Securities and Futures (Stock Market Listing) Rules (Cap 571V) ("SMLR"). These are statutory rules made by the SFC under the SFO. The SMLR already provides the statutory basis for the Dual Filing disclosure regime and contains embryonic disclosure rules.

- The SMLR will be amended to include all of the detailed disclosure requirements which currently appear in the Listing Rules, including those regulating the contents of listing documents, circulars and announcements, as well as financial disclosure and disclosure of price-sensitive developments.

- All provisions of Chapter 14 of the Listing Rules governing significant and connected transactions will also be included in the SMLR.

- The SFC will publish guidelines under section 399 of the SFO to inform the market about the detailed operation of these rules.

18. The disclosure requirements in the Listing Rules currently overlap with those in the Companies Ordinance. This is unnecessarily duplicative. The SMLR will contain all of the disclosure requirements that need to be satisfied for a prospectus issued by a listing applicant. The disclosure requirements in the Companies Ordinance will then be confined to prospectuses of unlisted private and public companies. The SFC will, as a disclosure regulator, resume functions to authorise prospectuses issued by listed companies for registration under the Companies Ordinance.

A flexible regime

19. Market rules must be flexible. This will be assured through (i) amending the SMLR to enable the SFC to exercise an appropriate degree of regulatory

discretion and (ii) expanding existing provisions of section 134 of the SFO, which enable the SFC to modify or waive the requirements of any rules made by it in specific cases, to cover listing applicants and listed companies. The SFC should also have the ability to issue class exemptions under the amended SMLR, in a similar manner to those it now issues under the Companies Ordinance.

20. Amending the SMLR in the manner proposed will be far more straightforward than the complex and lengthy procedure for making extensive amendments to primary legislation. Statutory rules such as the SMLR made by the SFC under the SFO become effective following "negative vetting" – they are laid before LegCo for comments for approximately 7 weeks following Gazettal. **Any rules the SFC proposes to make must also be subject to prior public consultation.** The SFC's extensive experience with the making of subsidiary legislation (most recently over 40 items made under the SFO) has been very positive. Negative vetting and public consultation achieves an appropriate balance between the need for legislative oversight and community consensus, and the ability to amend rules quickly to address evolving market conditions.

Safeguards and market input

21. The statutory disclosure and transactions regime must **incorporate rules to guarantee due process and provide adequate checks and balances** to ensure that it is operated fairly, consistently and transparently.

22. Sanctions for breaches of the SMLR must either be imposed by an expanded, adequately resourced, MMT established under Part XIII of the SFO to deal with listed companies, or by the SFC (in a manner similar to the way in which it exercises disciplinary functions in relation to intermediaries under Part IX of the SFO currently) and be subject to full merits appeal to the SFAT under Part XI of the SFO. If the MMT option is pursued the categories of market misconduct in section 245(1) of the SFO would be expanded to include breaches of the expanded SMLR.

23. All other decisions made under the expanded SMLR, including refusal to approve a prospectus or listing document, should be subject to full-merits appeal to the SFAT.

24. **Checks and balances over the SFC are already extensive.** Most are contained in the SFO, and are considered appropriate for an organisation that already regulates financial intermediaries, operates the Takeovers and Repurchase Codes, administers Dual Filing, regulates collective investment schemes and conducts statutory enforcement activities. They are also appropriate for the regulation of a statutory disclosure and transactions regime for listed companies.

25. **A committee comprised wholly of market participants,** with a weighting towards investor/buy-side representation, should be established by the SFC

under the SFO in place of its Dual Filing Advisory Group to advise it on prospectuses and other disclosure documents. The committee will also advise on decisions made by the SFC in the exercise of its discretionary powers when administering the SMLR, and have a key policy role if the SFC proposes to amend the new statutory disclosure and transactions regime in the SMLR.

26. **The SFC regulates a broad range of financial markets and market participants and is accordingly well placed to take the lead in regulatory reform** in line with its statutory function under the SFO "*to recommend reforms to the law relating to the securities and futures industry*". It has done so on numerous occasions – the most notable recent example being the SFO itself. The SFC's day-to-day contact with the wider market including, but ranging beyond, the listed sector contributes to its "market savvy".

Legislative blueprint

27. In short the SFC's legislative blueprint would comprise amending the SMLR to take in the disclosure and transactions Listing Rules and pursuing a discrete Bill to amend the SFO essentially containing the civil sanctions regime and amendments to section 134. The application of the Companies Ordinance would be clarified by an SFC class exemption to separate the disclosure requirements for unlisted companies (in the Third Schedule to the Companies Ordinance) from those for listed companies (in the expanded SMLR). The SFC will resume prospectus authorisation functions under the Companies Ordinance for listed offerings through the revocation of the Securities and Futures (Transfer of Functions – Stock Exchange Company) Order (Cap 571AE).

Funding

28. The SFC must be adequately resourced to operate effectively as the statutory regulator of corporate disclosure and transactions. SFC regulatory fees are charged on a cost-recovery basis. The SFC believes that its ability to charge fees at levels which cover its direct and indirect costs of regulation, but without any profit margin, will mean that the overall costs of listing regulation for the market should not increase as a result of its proposals.

Sponsors

29. Responses to the May 2003 HKEx/SFC Consultation Paper on the regulation of IPO sponsors reflected widespread concern that sponsors should not be subject to "double regulation" by HKEx (under the Listing Rules) and the SFC (under the licensing provisions of the SFO). HKEx had proposed additional Listing Rules requirements for sponsors because, as front-line regulator of listed companies, it has day-to-day contact with them when vetting prospectuses. Market concerns about "double regulation" would be resolved following the introduction of a statutory disclosure regime because a principal point of contact for sponsors would then be with the SFC.

Cross-Border Regulatory Co-operation

30. As more Mainland China enterprises, state-owned as well as private, come to our market, effective cross-border co-operation is critical. There is currently extensive contact between the China Securities Regulatory Commission ("CSRC") and the SFC, its statutory counterpart in Hong Kong. The SFC's role as statutory disclosure regulator will strengthen the ability of the CSRC and SFC to co-operate over a broader range of regulatory concerns. This will in turn enhance the ability to enforce the statutory disclosure and transactions rules effectively.

Response of the Securities and Futures Commission to the Government's Consultation Paper on Proposals to Enhance the Regulation of Listing

1. The Need for Reform

As a starting point, it is essential to identify (i) the extent of **consensus** for reform of listing regulation and (ii) which **deficiencies** of listing regulation are so critical as to justify legislative intervention.

1.1 *Consensus*

1.1.1 Hong Kong's future as an international financial centre depends on its success as "the premier capital formation centre of China"[1].

1.1.2 One of Hong Kong's principal attractions to domestic and international investors alike is the ability to invest in Mainland China companies in an advanced regulatory environment.

1.1.3 Hong Kong's main attractions to Mainland China companies are the opportunities to access foreign capital and to transform their corporate governance by demonstrating that they are capable of operating in an advanced regulatory environment.

1.1.4 This regulatory advantage, together with a highly developed legal and judicial system, is of vital importance to Hong Kong's competitiveness as a financial centre. This advantage is however under threat. Some commentators believe that Mainland China's stock markets will supplant Hong Kong and New York as the markets of choice for the country's larger corporations. This belief is based on the pace of China's growth, its efforts to improve corporate governance and expectations about eventual convertibility of the Renminbi. Singapore has also been able to attract a number of Mainland IPOs, and other international exchanges are competing actively to list Mainland companies.

1.1.5 It is essential that Hong Kong plays to its strengths in order to assure its future as a leading financial centre. One of its principal strengths is its system of financial regulation – a key objective must be to ensure that this system is world class. However in recent years criticism has been leveled at the manner in which companies listed in Hong Kong are regulated.

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[1] Paragraph 17 of the Address by the Chief Executive, the Honourable Tung Chee Hwa, at the Legislative Council Meeting on 8 January 2003.

1.1.6 The Expert Group and the SCCLR have advocated that a remedy is to be found in providing statutory backing or effect for the Listing Rules. A review of the financial media in recent years reveals numerous calls for change, including statutory backing. Listed companies in the United States, the United Kingdom, Australia and the Mainland are regulated through statutory rules. Hong Kong is out of line with these international standards.

1.1.7 HKEx[2] has also expressed clear views –

"*The central issue ... is that the Stock Exchange Listing Rules are currently being asked to carry a far too heavy regulatory load. This is happening because of a paucity of provisions in Hong Kong's primary legislation dealing with the conduct of HK listed companies and their directors, and the absence of a clear-cut mandate for the statutory regulator in this area.*

"The scope of the statutory mandate of the SFC to regulate the conduct of listed companies and their directors (in contrast with its mandate over market intermediaries) is considerably less extensive than that possessed by equivalent bodies in most other markets[3]."

"The dual filing system was a major advance in Hong Kong's regulatory regime, but it stops short of bringing Hong Kong's statutory disclosure regime fully into line with best international standards[4]."

1.1.8 HKEx has also indicated a preference for a "North American" model of market regulation. The SFC agrees with that preference. The model in the United States is described briefly in part 5 of this paper.

1.1.9 There is a clear consensus for change, and broad agreement that solutions to assure Hong Kong's future as a leading financial centre include giving SEHK Listing Rules statutory force. This consensus is also reflected in the Consultation Paper to which this paper responds.

1.2 ***Deficiencies***

1.2.1 *The Listing Rules do not have sufficient enforcement "teeth" in order adequately to deter non-compliance.* Over 80% of companies listed on

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[2] This response refers generally to Hong Kong Exchanges and Clearing Limited and its subsidiaries, including The Stock Exchange of Hong Kong Limited ("SEHK"), as "HKEx", distinguishing between them only when strictly necessary. References to the "Listing Committee" refer to both the Main Board and the Growth Enterprise Market ("GEM") Listing Committees. References to the "Listing Rules" refer to both the Main Board and GEM Listing Rules, save where referred to individually.

[3] Article in HKEx publication "Exchange", January 2003.

[4] HKEx response to the Consultation Paper, 14 January 2004.

HKEx are incorporated overseas, and the principal growth area is the listing of enterprises from Mainland China. Because most of our company law applies only to companies incorporated in Hong Kong there is heavy reliance on non-statutory Stock Exchange Listing Rules to regulate these listed companies. Breaches of the Listing Rules in practice lead only to reputational sanctions such as reprimands and public censures. These are inadequate to police properly rules which are vital for investor protection and market confidence.

1.2.2 *A lack of clear responsibility for corporate regulation.* A patchwork of listed company regulation is currently shared between the SFC and HKEx, and this had led to concerns about responsibility and accountability. Investors, issuers and intermediaries are confused about the role of each organisation in the regulation of listed companies, and overall regulatory effectiveness is reduced. Split regulation impacts particularly on effective enforcement. Although HKEx is the front-line regulator under the Listing Rules, the SFC shares the regulation of listing sponsors (as its licencees under the Securities and Futures Ordinance (Cap. 571) ("SFO")), conducts investigations into listed companies under the SFO and operates Dual Filing[5], also under the SFO. There is an urgent need for clarity.

1.2.3 *The perceived "profit versus regulation" conflict of interest at HKEx.* A widespread **perception** of conflict has given rise to public concern and debate, and in itself impacts on the reputation of Hong Kong's regulatory system. There is a perceived disincentive for HKEx as a listed for-profit company to invest in regulation and enforcement, a perceived incentive to maximise the number of new listings and a perceived incentive to favour the views of an important HKEx customer base – listed companies – when considering reforms to enhance investor protection. HKEx is bound by law to give precedence to the public interest under section 63(2) of the SFO. The same discipline applies to the SEHK (which administers the Listing Rules) under section 21(2) of the SFO. The perception of conflict is nevertheless difficult to manage in practice.

1.2.4 Questions about conflicts within HKEx have been raised publicly on many occasions. The Expert Group and other prominent commentators have expressed firm views. The fact that the perception of conflict leads to public debate and concern in itself impacts on the credibility of listing regulation in Hong Kong. Arguments to the effect that there is no real conflict, or that it does not in practice operate to influence decision-making by HKEx, are not adequate to deal with this perception.

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[5] "Dual Filing" refers to the provisions of the SMLR (which became effective on 1 April 2003) that require statutory filing of certain disclosure documents submitted to SEHK.

1.2.5 Attempts to resolve the perceived conflict have focussed on the separation of HKEx's listing regulatory unit (the Listing Division) from its "business" units and the HKEx Board. This involves delegation by the SEHK board of all of its powers and functions over listing matters to the Listing Committee. The Listing Committee has in turn arranged for most of these powers and functions to be discharged by the Listing Division and the SEHK's Chief Executive (these delegations are referred to in Chapters 2A and 2B of the Listing Rules). In effect a Chinese wall has been erected between the listing function and HKEx's other business activities.

1.2.6 Chinese walls are often used to address conflicts of interest in the financial industry – particularly conflicts within investment banks. However this solution at HKEx has resulted in an inability on the part of HKEx's Board to exercise meaningful control over a significant regulatory activity (front-line regulation of listed companies) which accounts for around 20% of HKEx gross revenues, notwithstanding the Board's full accountability for this activity to HKEx's own shareholders. The Chinese wall has not been effective to stem calls for reform arising out of the perceived conflict.

2. Market Quality and Regulation

2.1 Regulatory reform must enhance market quality. Market quality involves

- the types of companies admitted to listing;
- corporate governance; and
- the quality of disclosure.

2.2 The **types of company admitted to listing** are normally determined by **exchange rules** governing entry to and exit from proprietary trading platforms. Entry criteria deal mainly with quantitative listing qualifications such as track record, expected market capitalisation and public float. They also enable an exchange to apply subjective criteria such as "suitability for listing" (Listing Rule 8.04). Exit criteria include sufficiency of operations, insufficient public float, persistent rule breaches and, mirroring the entry criterion just mentioned, where "the Exchange considers that the issuer or its business is no longer suitable for listing" (Listing Rule 6.01). Control over the types of company admitted to listing through entry and exit criteria is a core aspect of the business of any exchange; all exchanges are entitled and expected to manage their own branding, reputations and business risks.

2.3 Notions of what types of company exchanges are prepared to admit to their trading platforms vary between jurisdictions, between individual exchanges in each jurisdiction, and between exchange boards. But in all cases exchange

entry criteria are vital to enable exchanges to compete effectively – particularly for those that are for-profit listed companies.

2.4 The application of exchange entry criteria to listing applicants is largely automatic; either the applicant has the required track record or it does not. Substantive compliance is in practice regulated through the obligation to make adequate disclosure in prospectuses. Subjective entry criteria such as "suitability for listing" involve an exercise of judgment, but reflect the prerogative of any exchange to manage the quality of its markets by refusing companies access to its trading facilities, even in cases where there are no problems with the quality of disclosure.

2.5 Entry criteria have a clear public interest dimension because they define the types of company which are able to tap retail and institutional investors through the public markets. Amendments to entry and exit criteria should therefore be subject to approval by an independent statutory regulator, as is the case now in Hong Kong. The statutory regulator should also supervise exchange administration of these rules. Supervision is particularly important if an exchange proposes to waive any of the criteria, either case-by-case or generally.

2.6 Non-statutory **exchange rules and codes** about **corporate governance** describe best practice standards expected by an exchange of companies granted the privilege of listing. These should set a higher standard than statutory governance rules. They normally deal with the relationship between a company, its directors, its larger (or controlling) shareholders and its public shareholders. Governance rules issued by exchanges range from corporate governance codes (HKEx is due to introduce a comprehensive new code) to provisions governing the permitted characteristics of share schemes and restrictions on corporate boards' authority to issue new shares without shareholder approval. These rules and codes are another aspect of the way in which exchanges legitimately manage the branding of their markets, their reputations and business risks.

2.7 Different jurisdictions allocate different types of governance rules between non-statutory exchange rules and statute. In the United States the reaction to the corporate scandals which unfolded in the wake of the bursting of the equity bubble in 2000 resulted in a shift towards a statutory governance regime through the Sarbanes-Oxley Act. Nevertheless, important non-statutory governance rules, such as those relating to independent directors, remain with the United States exchanges. In the United Kingdom gradual but significant governance reforms have focussed mainly on the non-statutory "Combined Code", developed by a series of independent committees and published by the Financial Services Authority ("FSA"). The substantive requirements of the Combined Code do not have statutory effect, but requirements to disclose against the Combined Code are contained in the FSA's Listing Rules, and breaches of these can lead to statutory sanctions.

2.8 Non-statutory governance rules are however important for investor protection and the public interest wherever they are housed. Those promulgated by HKEx are therefore subject to SFC policy input, their administration is subject to SFC supervision and amendments are subject to SFC approval under the SFO.

2.9 Publicly listed companies have a crucial obligation and responsibility to shareholders with respect to the **quality of disclosure,** since investors can only judge the quality of a company through timely access to accurate and reliable information. This information must be disseminated at the same time across the whole market so that all investors can make informed decisions and none are placed in a privileged dealing position. The importance of this principle to investor protection, and the potential for severe damage to the reputation of any financial centre if it is compromised, demands that it has statutory backing. Hence, throughout developed markets, such as the United States, the United Kingdom and Australia, the quality of disclosure is normally governed through **statutory rules** administered by a **statutory regulator**.

2.10 Disclosure rules in Hong Kong are spread among (i) the Listing Rules (ii) the SFO (principally Dual Filing under the SMLR – the Securities and Futures (Stock Market) Listing Rules made under the SFO) and (iii) Parts II and XII of the Companies Ordinance governing prospectuses. Fragmented or patchwork rules lead to regulatory gaps and overlaps, duplication of roles and lack of clarity about regulatory accountability. Too many of our detailed disclosure rules for listed companies are currently contained in the non-statutory Listing Rules and not in the law, and as a result Hong Kong's system of disclosure regulation does not have adequate "teeth".

2.11 Disclosure rules are designed to give fundamental protections to investors. Breaches should therefore lead to statutory sanctions with sufficient deterrent effect. The non-statutory regulatory regime in the Listing Rules cannot achieve this.

2.12 The Commission agrees with HKEx that giving statutory backing to the Listing Rules and a move towards a North American model would introduce for Hong Kong a statutory regime that is on par with practice in the United States, the United Kingdom and Australia. The division of responsibility between the HKEx and SFC would be clearly demarcated between non-statutory regulation by HKEx and a new statutory regime administered by the statutory regulator, the SFC.

2.13 This paper identifies a pragmatic and feasible blueprint for reform that:

- builds on the Dual Filing regime by introducing all the detailed disclosure obligations in the Listing Rules, together with the "notifiable transaction"

rules in Chapter 14 and its GEM equivalent, into existing subsidiary legislation under the SFO;

- clarifies the SFC's responsibility, as statutory regulator of listed company disclosure (which has already begun under Dual Filing), for the administration of the new statutory rules;

- ensures flexibility in the SFC's administration of the new statutory rules;

- introduces effective sanctions for breaches of the new statutory rules;

- includes extensive safeguards over the imposition of sanctions;

- creates a statutory public disclosure information database, similar to the United States EDGAR[6] system, that ensures that all statutory information is filed at one central source for maximum transparency; and

- achieves a regime that would be aligned with best practice in leading overseas financial centres.

3. The new statutory corporate disclosure and transactions regime: an outline

Building on Dual Filing under the SFO

3.1 The Dual Filing regime regulates some aspects of corporate disclosure through the SMLR, which is subsidiary legislation made by the SFC under the SFO. Although an improvement on the pre-SFO position, the SFC agrees with views expressed by HKEx and in paragraph 2.15 of the Consultation Paper that Dual Filing is not a sufficient answer to the deficiencies in listing regulation mentioned above. Breaches can only lead to criminal sanctions which involve considerable hurdles for regulators of market rules. Dual Filing does not impose positive obligations to disclose and therefore does not address cases of non-disclosure, late disclosure or selective disclosure. Neither does it set out detailed disclosure obligations; it instead relies on general principles. It also blurs further the regulatory roles and accountability of HKEx and the SFC.

3.2 Dual Filing was designed by the SFC as an interim measure for corporate disclosure regulation pending further reform. The next stage should centre on the introduction of a detailed disclosure regime under the SFO.

3.3 This will involve (i) incorporating into the SMLR all provisions of the Listing Rules that regulate or concern corporate disclosure (ii) the introduction into the SFO of civil sanctions, including fines and directors' disqualification orders for breaches of these new statutory provisions and (iii) establishing the SFC as statutory regulator of the new regime. It would be inappropriate for

[6] EDGAR stands for Electronic Data Gathering, Analysis, and Retrieval.

statutory rules carrying serious sanctions to be administered by a commercial enterprise.

3.4 Chapter 14 of the Main Board Listing Rules requires that (i) significant transactions proposed to be entered into by a listed company should be disclosed in detail to shareholders by way of announcement or shareholder circular (ii) larger transactions must be submitted to shareholders for approval and (iii) connected transactions (i.e. those between a listed group and its directors or substantial shareholders, and their associates) must be disclosed and, in some cases, put to independent shareholders for approval. These rules are of particular importance to investor protection in a market where companies are frequently closely controlled, and should be statutorily backed with effective enforcement teeth. Chapter 14 (as well as the equivalent GEM rules) should be incorporated into the SMLR and breaches be subject to civil sanctions.

HKEx will continue to administer Listing Rules

3.5 HKEx will continue to specify in its Listing Rules the types of company it is prepared to admit to trading by reference to objective, quantitative entry criteria as well as subjective tests such as "suitability for listing". It will continue to set exit criteria by reference to which companies may be delisted. It will also continue to specify the types of equity or debt-linked products it is prepared to list (e.g. warrants and structured products). These criteria will need to be adapted over time to take account of new types of listing applicants, new types of listed securities and products and, possibly, new trading boards targetted at specific types of companies and/or investors.

3.6 HKEx will also continue to set and administer all of the Listing Rules which concern conduct and corporate governance. It will continue to supervise market operations and regulate exchange participants under trading and clearing rules. In short HKEx will be front-line regulator of all Listing Rules save for the disclosure and transactions rules to be incorporated into the SMLR.

3.7 The SFC will under the SFO continue to monitor and supervise HKEx's administration of the Listing Rules. All Listing Rule amendments will, as now, require SFC approval. Statutory oversight is of particular significance in Hong Kong given that SEHK is a statutory monopoly and HKEx, with a wholly owned clearing function, controls a quasi-public utility. However with all disclosure and transaction rules incorporated into the SMLR and administered by the SFC, the area in which HKEx will have a perceived "profits versus regulation" conflict of interest will reduce substantially, and day-to-day oversight of HKEx by the SFC will be far less extensive than at present.

3.8 HKEx should retain a Listing Committee to provide market input when carrying out its remaining listing functions. These will include its power to

determine that a company is unsuitable for listing, its power to delist and the administration of all non-statutory rules and governance codes in the Listing Rules. The SFC recommends that membership of the Listing Committee should be reconfigured to include a greater weighting to investor representatives.

Enforcement and Sanctions

3.9 Under a regime which segregates clearly disclosure requirements (statutory) from other listing requirements (non-statutory), breaches of the Listing Rules will also normally involve breaches of the statutory requirements. For example, failure to comply with entry criteria specified in the Listing Rules will usually be accompanied by misleading disclosure in an IPO prospectus. In the United Kingdom the substantive provisions in the Combined Code are entirely non-statutory, but, as explained in paragraph 2.7, the obligation to disclose compliance under the Code is contained in the statutory listing rules, breach of which leads to statutory sanctions. This model should be followed in the SMLR to regulate the disclosure aspects of non-statutory "comply or explain" governance codes. Listing Rules breaches and failure to disclose compliance with non-statutory codes will as a result be capable of indirect statutory enforcement. This will in turn minimise overlaps and gaps between HKEx and SFC regulation.

3.10 A key aspect of reform will be to introduce meaningful sanctions for breaches of the new statutory disclosure and transaction rules. IPO disclosure is currently regulated under the prospectus provisions of the Companies Ordinance and the Dual Filing regime. Under these laws breaches can result only in criminal prosecution or civil suit by investors for damages. Most post-IPO disclosure is not dealt with by the Companies Ordinance. SFO provisions in this area are incomplete and the significant limitations of Dual Filing as an enforcement tool have already been highlighted.

3.11 Across all leading markets it is recognised that business misconduct is hard to regulate effectively through the criminal law. Investor protection based on "self-help" provisions in company or securities laws enabling shareholders to sue companies and directors are of limited utility in the absence of United States-style class action suits and contingency fees. In any event these techniques raise a host of difficult issues, which can only be tackled as an aspect of wider legal reform.[7] The practical barriers faced by private litigants in Hong Kong means that there is a greater onus on the role of regulators and law enforcement agencies to deter and punish corporate misconduct.

3.12 Civil sanctions are essential for effective enforcement of statutory disclosure and transaction rules. A civil standard of proof would apply (see further paragraph 6.21) and all of the SFC's investigatory powers would be employed to tackle suspected misconduct. The SFC already regulates licensed intermediaries through a civil disciplinary regime under Part IX of the SFO.

[7] These issues are under consideration in the context of the Civil Justice Reform exercise.

Sanctions for breaches of statutorily backed listing rules must include (i) civil fines against companies and directors and (ii) disqualification orders against directors. There should also be options to issue lighter sanctions for less reprehensible conduct (e.g. public reprimands), and to pursue criminal sanctions for more serious conduct.

Safeguards

3.13 A new statutory regime involving tougher sanctions must be subject to appropriate safeguards ensuring due process, transparency, consistency, and access to advice from committees comprising market participants.

Public filing of disclosure

3.14 Reform should provide a statutory basis for the public filing of all corporate disclosure documents, ranging from IPO prospectuses to annual reports and accounts, interim reports, shareholders circulars, announcements and takeovers documents. This would involve a positive statutory obligation to file with a public electronic database, and would be similar to the SEC-administered EDGAR system mentioned above.

3.15 A detailed legislative scheme for reform is described in parts 5 to 8 of this paper.

4. Collateral Issues

4.1 *Resolving problems arising from the segregation of listing functions at HKEx.* A number of problems result from the "Chinese wall" segregation of HKEx listing functions from other HKEx activities.

4.1.1 First, the communication barrier between the Listing Division and HKEx business units means that listing applicants in practice encounter a "3 stop shop" rather than a "1 stop shop". The 3 stops comprise HKEx's business units, the SFC (which administers Dual Filing, waivers under the Companies Ordinance and some Listing Rule waivers) and the Listing Division. Listing applicants find this division of roles confusing and frustrating – for example, HKEx's business units and the Listing Division are prevented by Chinese wall arrangements from discussing the application together.

4.1.2 Second, the regulatory Chinese wall does not address properly the perception of conflict when regulatory staff are compensated by reference to HKEx's financial performance and when regulatory budgets are set by the HKEx Board.

4.1.3 Third, a part-time unpaid Listing Committee cannot effectively perform its delegated functions to administer the Listing Rules and supervise the Listing Division. This is why the latest Listing MOU between SEHK and the SFC (signed on 28 January 2003) now omits

deliberately reference to these delegated powers. However the delegation of the listing function remains in place and is reflected in the Listing Rules.

It is essential that listing regulation is restructured to address these problems. The SFC's blueprint for reform, involving the transfer of disclosure and transactions Listing Rules into the SFO framework, will ensure that the area in which HKEx will have a perceived conflict of interest will reduce substantially. The Listing Committee system must also be reorganised to lighten members' workloads and enable it to operate primarily as an appeals, policy-making and disciplinary body. Proposals to reorganise the Listing Division and Listing Committee were made by HKEx in July 2002 but were not implemented.

4.2 *Resolving problems arising from undue regulatory interference.* HKEx administers non-statutory disclosure rules under contractual listing agreements which do not carry credible sanctions for breaches. This has contributed to a concentration of Listing Division regulatory effort on the pre-vetting of disclosure documents, with little emphasis on enforcement to deter misconduct and protect investors. This has led to a misallocation of responsibility and resources between HKEx and the market involving (i) over-reliance on the Listing Division by financial and other intermediaries and issuers to determine the content of prospectuses and continuing disclosure documents (ii) clearance of documents by the Listing Division operating as a de facto regulatory seal of approval (iii) disincentives for financial intermediaries to invest in execution, due diligence and advisory capability because of the heavy involvement of the Listing Division in the disclosure drafting process (iv) frequent suspensions of trading pending clearance of corporate announcements by the Listing Division and (v) market complaints about a bureaucratic, "box ticking" approach to pre-vetting by Listing Division front-line staff, together with a perception that staff often miss the forest for the trees (see paragraph 2.28, Expert Group report).

4.3 Statutory backing of disclosure will help redress the balance, allowing the market to function free from undue regulatory interference and frequent trading suspensions, but subject to credible statutory sanctions for breaches of disclosure and transaction rules. Regulators would be able to reduce substantially or eliminate pre-vetting of continuing disclosure (corporate announcements and some shareholders circulars issued by listed companies in the ordinary course). Rather than micromanaging the drafting of prospectuses and other disclosure documents regulators will move the emphasis from front-end vetting to back-end enforcement to deter substandard work. They will also focus on high level, rather than mechanical, checklist-based vetting of IPO prospectuses. This would align Hong Kong with best practice in the major overseas markets.

4.4 *Resolving problems with checks and balances.* Checks and balances over the work of the Listing Division involve (i) oversight by the Listing Committee and (ii) oversight by the SFC.

4.4.1 A part-time unpaid Listing Committee faces severe practical difficulties in carrying out its delegated responsibility to supervise a Listing Division with staff numbering over 110. Paragraphs 1.2.5, 1.2.6 and 4.1.3 above discuss some implications of this. Reform will enable the Listing Division to work more closely with other HKEx units and relieve the burden on the Listing Committee as the SEHK Board's delegate for all listing matters.

4.4.2 The principal check and balance over HKEx in the SFO is the SFC's function to supervise and monitor the Listing Division (section 5(1)(b) of the SFO). The SFC is a public interest regulator and its supervision, in theory, should compensate for some of the practical problems arising from the delegation of responsibility for listing within HKEx to the Listing Committee. Experience has shown that this supervisory and monitoring role is difficult to operate in practice.

(a) The principal regulatory tools available to the SFC in relation to HKEx are its power under the SFO to issue restriction notices and suspension orders against HKEx and the SEHK, as well as the power to make or amend Listing Rules for the SEHK where it refuses an SFC written request to do so. These are "nuclear" options which are only suitable to address a crisis. Their use other than in extreme circumstances would risk impacting seriously on Hong Kong's reputation as an international financial centre and would inevitably damage (probably irreparably) the working relationship between the SFC and HKEx.

(b) Supervision of day-to-day activities of the Listing Division rests in practice on persuasion and comment communicated through regular meetings, informal contact and periodic performance reviews. These techniques are difficult to operate in practice and are of limited effect. Listing Division staff are HKEx employees; the SFC has no influence over their remuneration, job security and prospects. Friction and communication problems are inevitable. Given that the Listing Division and the SFC deal with the same regulatory subject matter there is also an inbuilt assumption underlying the supervisory concept that SFC staff have greater regulatory expertise or insight than Listing Division staff. HKEx has expressed frustration with a system whereby a regulator is expected to regulate another regulator.

> *" The way the relationship should work … is that the Exchange and Listing Committee should carry out their day to day functions without being "micro managed" by the SFC. …If the SFC becomes dissatisfied with HKEx's performance of its duties it should voice its concern at the top level… If the SFC is subsequently not satisfied corrective action has been taken, it has the "nuclear" option of withdrawing HKEx's listing responsibilities".* (HKEx's 2nd submission to the Expert Group, December 2002).
>
> A regulatory structure that concentrates disclosure and transaction regulation in a statutory regime administered by the SFC will reduce the areas of HKEx work over which the SFC will need to exercise statutory oversight. The SFC should also be able to adopt a lighter touch when supervising and monitoring HKEx's remaining listing activities.

4.5 *Resolving concerns about an overly powerful SFC.* Concerns have been expressed that if the SFC expands its role to that of a statutory disclosure and transactions regulator it will become too powerful. It has also been said that SFC regulation will be bureaucratic, risk averse and will inhibit market development. The fear is that this will discourage smaller companies from listing, whether from Mainland China, locally or elsewhere.

4.6 This argument is difficult to sustain when applied to other statutory regulators in the United States, United Kingdom and Australia, which perform functions similar to those proposed in this paper.

4.7 Existing checks and balances over the SFC are very extensive. They include:

- the independent Process Review Panel established by the Chief Executive in November 2000 to review the SFC's procedures on an ongoing basis;
- annual budget approval by the Chief Executive following tabling in LegCo;
- the SFC's annual report must be sent to the Financial Secretary and laid before LegCo;
- the appointment by the Chief Executive of the external members of the SFC Advisory Committee;
- the appointment of SFC Board members by the Chief Executive;
- the presence of a majority of independent Non-Executive Directors on the SFC Board;

- full merits appeals of SFC decisions of the Takeovers Executive to the independent Takeovers Panel;

- full merits appeals of SFC decisions to the independent Securities and Futures Appeals Tribunal ("SFAT") (chaired by a High Court judge);

- the referral of all civil market misconduct cases to the Financial Secretary with a view to his deciding whether or not to institute proceedings before the independent Market Misconduct Tribunal ("MMT") (also chaired by a High Court judge);

- decision by the Magistrates' Courts on criminal market misconduct matters and other offences prosecuted by the SFC;

- Government oversight in a policy role;

- SFC public consultation on draft subsidiary legislation to be made by it;

- Ombudsman jurisdiction and susceptibility to judicial review; and

- the ability of the Director of Audit to examine the records of the SFC.

4.8 Most checks and balances over the SFC are set out in the SFO, and are considered appropriate for an organisation that regulates financial intermediaries, operates the Takeovers and Repurchases Codes, administers Dual Filing, regulates collective investment schemes and conducts a range of statutory enforcement activities. They are also appropriate for the administration of a statutory disclosure and transactions regime for listed companies within the SFO framework.

4.9 The SFC has since its inception established a clear track record in the development and regulation of the broader financial markets including, but ranging far beyond, the listed company sector. It administers the Codes on Takeovers and Share Repurchases and five Codes governing the authorisation of a range of collective investment schemes. It authorizes under the Companies Ordinance prospectuses for all offers of unlisted shares, bonds and structured products, and grants exemptions from specific prospectus requirements for both listed and unlisted issues. It administers the Dual Filing regime for listed companies. It regulates directly all securities market intermediaries, including IPO sponsors, and takes enforcement action against market misconduct.

4.10 This broad competency means that the SFC is best placed to be a leader in regulatory reform to develop the market. The SFO states that a specific function of the SFC is "*to recommend reforms of the law relating to the securities and futures industry*" (section 5(1)(p)). The most notable recent example is its work on the SFO itself. Other recent examples in the listed

sector include subsidiary legislation on price stabilization[8] under the SFO, a series of guidelines and class exemptions under the Companies Ordinance to enable issues of bonds and structured products to be made more efficiently, and the issue of a stand-alone Code for listed REITs in response to market demand. In each case the SFC has responded to market needs quickly, balancing market development with investor protection.

4.11 The SFC therefore rejects the suggestion that reform risks stifling market development; on the contrary a comprehensive statutory disclosure regime will result in a better quality, more dynamic market.

4.12 Bad disclosure harms investors and should be the subject of stern enforcement. Regulators must have the tools to enable tougher measures to be taken against misconduct. The ability to reallocate regulatory resources from pre-vetting work to enforcement following the introduction of statutory disclosure rules will however lighten the overall compliance burden, freeing issuers and intermediaries to take appropriate responsibility for their disclosure documents. Those who breach the rules will face stern enforcement action. Those who do not will be subject to less regulatory interference. A clear vertical separation of competence between the SFC (statutory disclosure and transaction rules) and HKEx (non-statutory Listing Rules) will clarify roles and public accountability.

4.13 *Resolving concerns about "market savvy" and closeness to the market.* It has been said that the SFC may not be an effective or sufficiently responsive regulator because it is remote from the market and has little "market savvy".

4.13.1 As mentioned in paragraph 4.9 above the SFC has direct day-to-day contact with a broad range of market sectors which undoubtedly contributes to market savvy. In regulating the investment funds industry, it taps market intelligence through its Committee on Unit Trusts and Committee on Investment-Linked Assurance and Pooled Retirement Funds, plus its Committee on REITs. It regulates financial intermediaries (including those who advise on listing matters), and is currently gathering views about the regulation of the brokerage industry through the Working Group on Review of the Financial Regulatory Framework for Intermediaries. It consults the Securities and Futures Market Development Working Group (and three sub-groups) under the Administration's Market Development Task Force. It consults its Shareholders Group on matters of concern to investors. It consults the Dual Filing Advisory Group on doubtful IPO disclosure cases. All of the above Groups and Committees, both statutory and *ad hoc*, have extensive market representation. The SFC also consults the market generally on reform initiatives through public consultation and prior "soft consultation" with groups of interested or affected market

[8] Securities and Futures (Price Stabilizing) Rules (Cap. 571W)

participants. Finally, the SFC also liaises directly with HKEx's business units on a range of regulatory and market development issues.

4.13.2 "Market savvy" is mainly about people. Any regulator must strive to recruit and retain experienced market professionals, particularly at senior levels. The SFC and HKEx recruit staff from the same pool and both must strive to ensure quality teams. Advisory and decision making bodies such as the Listing Committee, comprised of market participants, will also continue to be a vital part of the regulatory structure. The role of these types of body following reform is discussed in part 7 of this response.

4.13.3 The proposals in this response will contribute to an increase in the quality of regulation because regulatory staff will have a new role. Regulators within the SFC will be able to operate effectively within a sound statutory framework, concentrating on enforcement, specific requests for rulings and rule waivers, and post-vetting rather than detailed pre-vetting.

4.14 *Resolving concerns about unclear roles and responsibilities*.

4.14.1 In recent years there has been considerable public uncertainty about which regulator is responsible and publicly accountable for corporate disclosure and conduct. HKEx is the "front line regulator" of listed companies. The SFC also has a role through Dual Filing and the SFO, including corporate investigations.

4.14.2 Reform must include a clarification of regulatory roles and responsibilities. Detailed statutory disclosure and transaction rules, all of which will be transferred from the Listing Rules into subsidiary legislation under the SFO, will be administered and enforced by the SFC which would be fully accountable to the public for its statutory role. HKEx will be the regulator of non-statutory listing and other rules. It would be responsible for the quantitative criteria which companies have to meet to list on its markets, set exit criteria and promulgate non-statutory conduct rules and best practice codes, including those relating to corporate governance (subject to SFC approval under the SFO). It will also continue to supervise market operations and regulate exchange participants through its trading and clearing rules. Any confusion caused by overlapping HKEx/SFC competencies in disclosure regulation under Dual Filing will also be resolved.

4.14.3 HKEx has suggested a solution for statutory backing which centres on the inclusion of "core" principles for continuing disclosure obligations in the primary law. The detailed disclosure requirements would remain in the non-statutory Listing Rules and would continue to

operate as contractual obligations with listed companies. There are some serious difficulties with this proposal.

- First, it would be difficult in practice to enforce "core" disclosure principles in the primary law by reference to specific breaches of detailed disclosure requirements set out in non-statutory Listing Rules. A breach of one will not necessarily lead to a breach of the other and to prove that it does so risks complex, costly enforcement cases. The existing statutory regime for prospectuses (Parts II and XII of Companies Ordinance) is founded on a general disclosure principle in Paragraph 3 of the Third Schedule, followed by detailed disclosure requirements in the remainder of the Schedule. A breach of either the general principle or a specific requirement gives rise to identical liability. It is in most cases far easier to establish breach of a specific requirement than a general principle. This model – principles articulated by detailed statutory disclosure requirements – is essential to enable the regulator to enforce effectively a credible statutory disclosure regime.

- Second, fragmentation of disclosure obligations between the primary law and detailed Listing Rules would increase public uncertainty about regulatory roles, responsibility and accountability between the SFC and HKEx. It would be even more difficult than now for the public to determine which regulator is responsible for which aspects of corporate disclosure – for example, would the SFC just tackle the "serious" cases and, HKEx handle with the rest? How would "serious" cases be identified? It would also deepen confusion about the appropriate agency to conduct investigations and take disciplinary action for breaches of non-statutory Listing Rules, on the one hand, and the statutory provisions, on the other. The door would be open to increased regulatory arbitrage. MOUs are not an adequate solution. There should instead be a clear separation of roles; the SFC must be responsible for all disclosure and transactions regulation under the SFO and HKEx must be responsible for non-statutory Listing Rules. The result should be seamless regulation and effective enforcement of market rules.

- Third, potential solutions involving "backing" of non-statutory Listing Rules by attaching statutory legal consequences to any breach would result in all of the rules themselves becoming statutory. Similar problems arise if non-statutory Listing Rules (or waivers made under them) are characterised as safe harbours from statutory provisions.

- Fourth, primary law is rigid; the legislative process to amend it to take account of market development needs or investor protection

concerns is complex and lengthy. Subsidiary legislation for market rules within the SFO framework is sufficiently flexible, well-tested and accepted in practice.

- Fifth, a regime where "core" principles are in primary legislation, but the detailed non-statutory rules are implemented by HKEx as front-line regulator, would do little to address concerns about perceived conflicts of interest at HKEx.

4.14.4 For maximum effectiveness and flexibility the practical option is to put all disclosure obligations ("core" and detailed) into the SFO framework as subsidiary legislation.

4.15 *Resolving concerns about "legalistic" rules*. Some commentators fear that making Listing Rules statutory would require them to be redrafted and applied in a rigid, legalistic manner. Statutory rules made as subsidiary legislation under the SFO are in fact capable of being formulated in a manner which ensures flexibility – the Financial Resources Rules[9] for brokers are a good example. Rules can describe areas of regulatory discretion and they can be waived or modified in specific cases. The existing Listing Rules are in practice applied in a legalistic manner and precedent plays an important part in interpretation; advice on Listing Rules occupies a large part of the practice of corporate finance lawyers. The rules are in parts drafted in complex language that is difficult to understand – Chapter 14 is an example of this. Rather than making the rules more legalistic, reform is an opportunity to rationalise the disclosure and transaction requirements in order to make them more user-friendly. The United Kingdom Listing Rules (which are written and administered by the FSA and about to undergo further reform) are a good example of clearly drafted statutory rules which are reviewed regularly to accommodate market development.

5. The North American Model

5.1 HKEx has advocated a North American regulatory model for Hong Kong.

5.2 New York is the world's leading equity market, with two main exchanges – the New York Stock Exchange ("NYSE") and the NASDAQ Stock Market, Inc ("NASDAQ"). The SEC is the statutory regulator. ***Appendix I*** compares the SEHK Listing Rules with the rules governing companies listed on NYSE. It shows which of these rules in the United States are statutory and which are non-statutory.

5.3 The main difference between the Hong Kong and SEC/NYSE regime is that the SEC operates as the statutory regulator of disclosure administering detailed disclosure rules under federal laws – chiefly the Securities Act 1933 and the Securities Exchange Act 1934. The SEC accepts registration statements

[9] Securities and Futures (Financial Resources) Rules (Cap. 571N)

(prospectuses) for filing and review, administers laws concerning disclosure in financial and proxy statements, reviews corporate accounts and regulates tender offer (takeover) documents. It operates the "EDGAR" electronic filing system through which all corporate disclosure documents are publicly accessible. It also approves exchange rule amendments.

5.4 The NYSE operates non-statutory rules – the Listed Company Manual – covering entry and exit criteria, codes of business conduct, ethics and governance. NASDAQ operates similar rules. Recent examples of United States exchange rules were approved by the SEC in November 2003. These new NYSE and NASDAQ rules introduced strengthened corporate governance standards for listed companies, including a stricter definition of independence for directors, a requirement that a majority of boards are independent as well as provisions facilitating independent director oversight.

5.5 The United States system segregates clearly responsibility for **statutory** disclosure rules undertaken by the SEC and **non-statutory** exchange rules operated under SEC supervision. The SEC's disclosure review (vetting) function developed naturally from its role as the lead enforcement agency for disclosure under United States federal law; there is little purpose for a listing applicant to approach an authority other than the ultimate enforcement agency to comment on a registration statement prior to the launch of a public offering.

5.6 Following implementation of the reforms in this paper the regulatory division of work in Hong Kong would resemble closely that in the United States, where the SEC is the statutory regulator of corporate disclosure and NYSE/NASDAQ handle other aspects of listing regulation.

6. The New Legislative Framework.

Expanding the SMLR

6.1 The SFC's blueprint for reform centres on the introduction of the disclosure and transactions rules now contained in the Listing Rules[10] into subsidiary legislation under the SFO. The legislative proposal is straightforward, functions within the existing SFO framework and is capable of being operated flexibly to meet evolving market development and investor protection needs.

6.2 The principal vehicle for the new regime should be the existing SMLR. These are Rules made by the SFC under section 36 of the SFO. The SMLR already provides the statutory basis for Dual Filing and in section 3 contains embryonic IPO disclosure rules (***Appendix II***).

6.3 Section 3(a) of the SMLR provides that "*[a]n application for the listing of any securities … shall comply with the rules and requirements of the recognised exchange company to which the application is submitted …*". This provision

[10] References in this section to the Main Board Listing Rules should be taken also to refer to equivalent GEM Listing Rules.

should remain unchanged because HKEx will continue to set and administer criteria for the admission of companies to trading.

6.4 Section 3(c) of the SMLR provides that a listing application must contain "*such …information which…is necessary to enable an investor to make an informed assessment of the activities, assets and liabilities and financial position, of the applicant…*". This general standard of disclosure is similar to that in paragraph 3 of the Third Schedule to the Companies Ordinance[11] governing the contents of all listed and unlisted prospectuses. It should be supplemented by inclusion in the SMLR of all the detailed disclosure requirements in the Listing Rules.

6.5 These will include (i) the disclosure requirements in Appendix 1 to the Listing Rules, which prescribes the detailed contents of listing documents as well as the contents of other circulars and announcements (ii) the disclosure requirements for financial statements in Appendices 15 and 16; and (iii) those aspects of the listing agreements in Appendix 7 which also concern disclosure and financial statements. Detailed disclosure requirements in other chapters of the Listing Rules would also be included. A full description is set out in ***Appendix III***.

6.6 Listing Rules dealing with topics such as the methods of listing, qualifications for listing, applications for listing, mandatory requirements for articles of association, the regulation of share schemes and the regulation of share repurchases etc would remain and continue to be administered by HKEx. Aspects of Listing Agreements in Appendix 7 to the Listing Rules which concern preemptive rights, share issue mandates, notification, trading and settlement would also remain, as would rules that define listed financial products and regulate their trading (Chapters 15 – Options, Warrants and Similar Rights, Chapter 15A – Structured Products and Chapter 16 – Convertible Equity Securities). Details are set out in ***Appendix IV***. The disclosure aspects of these rules, would, however, be included in the SMLR. The Code of Best Practice in Appendix 14 is about to be upgraded substantially to match international corporate governance standards, and will incorporate a "comply or explain" regime along the lines of the United Kingdom's Combined Code. This will be an important element of the Listing Rules in future.

6.7 Paragraph 3.4 above discusses statutory backing for the significant and connected transaction provisions of Chapter 14 of the Listing Rules. Chapter 14 covers the following main areas:

- descriptions of the types of transactions governed by the Chapter;

[11] "Sufficient particulars and information to enable a reasonable person to form as a result thereof a valid and justifiable opinion of the shares or debentures and the financial condition and profitability of the company at the time of the issue of the prospectus."

- mandatory disclosure; and

- requirements to obtain prior independent shareholder's approval in the case of larger transactions or transactions with connected parties.

6.8 Disclosure obligations in Chapter 14 can be treated in the same manner as other disclosure obligations to be included in the SMLR (paragraph 6.4 above).

6.9 The rules which identify the types of transactions that trigger disclosure and shareholder approval requirements need special treatment in the SMLR to enable the SFC to exercise an appropriate degree of regulatory discretion. This, as now, will be important for the administration of proposed transactions submitted to the regulator for consideration under the rules. The SFC must have flexibility to determine the class of persons who are deemed to be "associated" with a connected person. It will also need to have a discretion to determine on a case-by-case basis the precise application of the various "size" tests, as well as the application of "de minimis" and other exceptions to the rules. These discretions are already contained in Chapter 14, and need to be dealt with specifically in the SMLR. The Chapter 14 regime should have statutory effect as follows:

- All of the notifiable and connected transaction rules should be set out in full in the SMLR.

- The rules should describe clearly the ambit of SFC discretion. The SFC should have a limited discretion to widen the scope of persons caught by the connected transaction rules before a transaction is put to shareholders for a vote. It should also be able to rule, in accordance with SMLR principles, on those eligible to vote at shareholders' meetings to approve large or connected transactions.

- Flexibility to grant waivers or modifications of the statutory rules in specific cases will be incorporated into the SMLR and also assured through section 134 of the SFO (this is discussed in more detail in paragraphs 6.12 to 6.14 below).

- The SFC should publish guidelines under section 399 of the SFO concerning the manner in which it will administer the SMLR.

These measures will ensure that the SFC, as statutory regulator, will be able to operate statutory transaction rules in a manner which balances certainty for the market with a sufficient degree of flexibility to take account of individual cases.

6.10 It is relevant to note that the SFO already recognises the SFC's ability to exercise regulatory discretion. For example, section 193(1)(d) defines

"misconduct" for the purposes of Part IX (discipline of intermediaries) as including *"an act or omission relating to the carrying on of any regulatory activity for which a person is licensed or registered which,* ***in the opinion of the Commission****, is or is likely to be prejudicial to the interest of the investing public or to the public interest*". General standards of conduct expected of intermediaries are elaborated in Codes of Conduct and Fit and Proper Guidelines made under section 169 or 399 of the SFO. The proposed new regime would therefore be consistent with the existing SFO scheme.

6.11 The SFC will issue Guidelines to be made under section 399 of the SFO (together with subsequent proposed amendments) for prior public consultation before they are finalized. Guidelines will not need to be laid before Legco for negative vetting because they do not alter any statutory requirements.

Flexible Market Rules

6.12 Making and amending an expanded SMLR will be more straightforward than the complex and lengthy procedure for making and amending primary legislation. Statutory rules made by the SFC under section 36 of the SFO become effective following "negative vetting" – they are laid before Legco for comments for approximately 7 weeks following Gazettal. Any rules that the SFC proposes to make must also be issued for public consultation (section 398 of the SFO). This would normally follow informal market soundings. Negative vetting and public consultation achieves an appropriate balance between the need for legislative oversight and community input, and the ability to amend rules quickly to address evolving market conditions.

6.13 The SFC's recent experience with the enactment of over 40 items of subsidiary legislation made under the SFO was very positive. LegCo was able to vet this considerable body of legislation so that the SFO could commence one year after its enactment in March 2002. Amendment of the SMLR to incorporate Listing Rules governing disclosure and transactions would be far less complex and the rules themselves should not be controversial because they are not new. It is also unlikely that statutory disclosure and transaction rules would require frequent amendment following their introduction. The detailed prospectus contents requirements in the Third Schedule to the Companies Ordinance have not been updated significantly since 1992 and the bulk of it dates from 1972. This is partly due to the flexibility that is assured through the SFC's ability to grant individual and class exemptions.

6.14 A similar flexibility for an expanded SMLR will be assured through section 134 of the SFO. This enables the SFC, on application, to modify or waive the requirements of any provision of any Rules made by it under the SFO in any particular case, including the SMLR. Section 134(1) simply needs to be amended to enable listed companies and applicants for listing to be included in the list of persons able to apply for modification or waiver. The SFC should also have the ability to issue class exemptions to the SMLR disclosure and transaction rules, tracking its existing ability to issue class exemptions under

the Companies Ordinance. These class exemptions will (as with their Companies Ordinance equivalents) be treated as subsidiary legislation subject to negative vetting by LegCo.

Format of new Statutory Rules

6.15 The new legislation should be set out as follows:

- The main body of the SMLR should contain "high level" general principles of disclosure similar to those now contained in section 3, but expanded to deal with positive obligations for IPO and continuing disclosure.

- Detailed disclosure requirements, ranging from the content and timing of financial statements to obligations for the timely and even dissemination of price sensitive information, as well as detailed contents requirements for listing and other corporate disclosure documents (including prospectuses, circulars and announcements) should be contained in a schedule to the SMLR.

- A new section should be included in the main body of the SMLR containing the basic principles regulating significant and connected transactions (i.e. those currently regulated by Chapter 14 of the Listing Rules).

- A separate schedule should contain the detailed rules, exemptions and discretions now contained in Chapter 14 of the Listing Rules.

- Guidelines should be published under section 399 of the SFO to inform the public about the detailed operation of the SMLR.

Companies Ordinance

6.16 The scope of the Companies Ordinance will be redefined. The disclosure requirements of the Listing Rules currently overlap with those in the Third Schedule. This is unnecessarily duplicative. The SMLR should contain all disclosure requirements that must be satisfied before a prospectus issued by a listed company can be authorized for registration under the Companies Ordinance. The Third Schedule of the Companies Ordinance should be confined to unlisted private and public companies. This distinction would be similar to that between the United Kingdom Public Offering of Securities Regulations 1995 (unlisted, issued by the United Kingdom Treasury) and the Listing Rules (listed, made by the FSA under the Financial Services and Markets Act 2000 ("FSMA")). The split between listed and unlisted company disclosure can be achieved via a new class exemption under the Companies Ordinance, which will operate as subsidiary legislation.

6.17 The SFC must also resume under section 25 of the SFO its functions to authorise prospectuses for registration under sections 38D and 342C of the

Companies Ordinance. The SFC currently grants exemptions to listing applicants from compliance with contents and other provisions of the Companies Ordinance relating to prospectuses, whereas SEHK authorizes prospectuses for registration under the Securities and Futures (Transfer of Functions – Stock Exchange Company) Order (Cap. 571AE). Compliance with the SMLR disclosure rules will enable the SFC to authorise directly a prospectus for registration under the Companies Ordinance.

HKEx supervision and duties

6.18 The provisions of the SFO which require the SFC to supervise and monitor HKEx's activities, as well as to approve listing rule changes, will continue to be an important public interest check and balance.

6.19 SEHK's duties under section 21 of the SFO would remain unchanged. These include the overall duty to ensure, so far as reasonably practicable, an orderly, informed and fair market. HKEx will continue to be responsible for the direct supervision of market operations, including trading across its platform and clearing through CCASS.

Sanctions

6.20 Statutory civil sanctions for breaches of the SMLR will be set out in the SFO as primary legislation. These will include (i) fines for companies and directors; and (ii) disqualification orders for directors. Lighter sanctions, such as reprimands and censures, should be available for use in less serious cases.

6.21 Sanctions can be modeled on the provisions in Part IX of the SFO concerning the discipline of intermediaries. These involve civil fines, revocation or suspension of licences or registrations, and prohibitions. They could alternatively be modelled on the orders available to the MMT in Part XIII. If the option of the SFC as sanctions decision-maker were pursued (see paragraphs 6.27 to 6.29) then we would apply a high civil standard of proof (a high degree of probability). If the option of the MMT as sanctions decision-maker were pursued, although it has not heard any cases yet, its predecessor, the Insider Trading Tribunal (which is still operating) applies that standard.

6.22 The criminal Dual Filing regime contained in sections 5 and 7 of the SMLR and section 384 of the SFO already enables enforcement authorities to opt for criminal prosecution in serious cases.

Safeguards

6.23 The new regime must include sufficient safeguards to ensure that sanctioning powers are operated fairly and openly.

6.24 Paragraphs 4.5 to 4.8 deal with the extensive checks and balances over the SFC and part 7 of this paper deals with market input and appeals against decisions made under the SMLR.

6.25 There is also a need to legislate for transparency and procedural fairness. The manner in which the United Kingdom's FSMA deals with penalties which may be imposed by the FSA on companies and their directors for listing rule breaches is a useful reference point. Section 91 provides that if the FSA considers that an issuer or an applicant for listing has contravened any provisions of the listing rules it may impose a penalty of such amount as it considers appropriate. If in such a case the FSA considers that a person who was at the material time a director was knowingly concerned in the contravention, it may also impose a penalty on him. Section 91 also enables the FSA, instead of imposing a penalty, to issue a public censure. Further provisions provide that the FSA must first give a warning before it takes action. It must also prepare a policy statement with respect to the penalties it may impose. The policy must have reference to the seriousness of the contravention, the extent to which the contravention was deliberate or reckless and whether the penalty is to be imposed on an individual. The statement must be issued in draft for public consultation before approval. Finally, any person against whom the FSA decides to take action may refer the matter to the Financial Services and Markets Tribunal.

6.26 The relevant sections of the FSMA, together with its fining guidelines, are at ***Appendix V***.

6.27 Part IX of the SFO contains the disciplinary regime for intermediaries regulated by the SFC. Aspects are similar to the FSMA regime described above. Part IX provides, in sections 198 to 199:

- that the SFC may not exercise its power (e.g. to fine or revoke a licence) without giving the person in respect of whom the power is to be exercised a reasonable opportunity of being heard;

- that any disciplinary decision must contain a statement of reasons and other prescribed information; and

- that the SFC may not exercise its power to fine until it has published fining guidelines. These must include reference to whether conduct was intentional, reckless or negligent, whether the conduct damaged the integrity of the market, whether the conduct caused loss to or imposed costs on any other person and whether the conduct resulted in a benefit to the person being fined or any other person. The fining guidelines are at ***Appendix VI.***

Sanctions imposed by the SFC under Part IX of the SFO are in all cases subject to full-merits appeal to the SFAT. The SMLR regime for listed companies and their directors would have many similarities within the Part IX SFO regime for intermediaries.

6.28 These SFO and FSMA provisions operate as safeguards over fining and other sanctioning powers exercisable by the SFC and FSA directly. Another option is to provide that statutory sanctions for breaches of the SMLR should only be imposed by a body independent of the SFC. Part XIII of the SFO established the MMT to which civil market misconduct cases are referred via the Financial Secretary, usually following SFC investigation. The MMT has a range of sanctions available to it under section 257 of the SFO, including disqualification orders and civil fines. Cases brought under the expanded SMLR could be referred by the SFC to an additional independent MMT (as envisaged by section 251(7) of the SFO) dedicated to dealing with listed company disclosure and transactions regulation under the SMLR.

6.29 Either of these models – statutory civil sanctions imposed by the SFC subject to full-merits appeal to the SFAT or statutory civil sanctions imposed by the MMT – would be suitable for a new statutory disclosure and transactions regime under the SMLR. If the MMT model is adopted it would be essential to ensure that it is properly resourced to avoid the risk of caseload bottlenecks and delay.

7. Market Input

7.1 External market input is essential to the regulatory process. A committee comprised wholly of market participants (with a weighting toward investor/buy-side representation) should be established by the SFC under section 8 of the SFO to advise the SFC on any listing application which the SFC, in its capacity as disclosure regulator, proposes to reject under section 6 of the SMLR or any prospectus which the SFC proposes to refuse to authorize for registration under the Companies Ordinance. This committee will replace the current Dual Filing Advisory Group.

7.2 Administration by the SFC of substantial and connected transactions under the SMLR (i.e. existing Chapter 14 of the Listing Rules) will, as mentioned above, involve the exercise of regulatory discretion. The SFC does not believe that it is efficient for first instance day-to-day regulatory decisions to be made by a committee comprised of external market participants. The new section 8 market committee should therefore function as an advisory body in respect of decisions made by the SFC when exercising its discretionary powers. All SFC decisions should however be subject to full-merits appeal to the SFAT, and appropriate lay members could be empanelled to handle appeals from this type of decision. Schedule 8 to the SFO would be amended by subsidiary legislation to include an expanded list of specified decisions, appealable to the SFAT. As mentioned above, the imposition of statutory sanctions for breaches of these rules should be subject to the same regulatory safeguards as sanctions for breaches of disclosure rules – either MMT as a first instance decision maker or SFAT full-merits appeal.

7.3 The new section 8 market committee should also have key advisory role when the SFC proposes any amendments to the SMLR disclosure and transactions rules.

7.4 The SFC strongly recommends that the SEHK retains the Listing Committee to assist in the administration of the Listing Rules. Its principal function will be to advise and decide on Listing Rule amendments (subject to SFC final approval as at present), deal with disciplinary cases arising from breaches of the non-statutory rules that remain with HKEx and act as an appeal body for other Listing Division decisions.

8. **Public Disclosure Database**

The SMLR should contain a positive statutory obligation on listed companies to file all corporate information covered by the SMLR disclosure and other statutory provisions in a publicly accessible electronic database, similar to the SEC's EDGAR system. Transparency is key to market confidence and therefore any failure to file should be subject to the same sanctions that can be imposed for breaches of the substantive disclosure and transactions rules to be included in the SMLR. The database will ensure that investors worldwide would have access to information on Hong Kong listed securities and products, irrespective of whether these are stocks, bonds or derivatives.

9. Funding

9.1 The SFC will need to be adequately resourced to operate effectively as a statutory regulator of corporate disclosure and transactions under the SMLR.

9.2 Currently HKEx funds the SFC's Dual Filing work by remitting to the SFC $20 million per annum. This amount will be insufficient to resource an expanded SFC capability under the SMLR.

9.3 The Expert Group recommended that the entire listing function should be transferred to the SFC and that HKEx be entitled to retain all surplus revenue generated i.e. the transfer should be "bottom-line neutral" for HKEx. In HKEx's 2002 annual report, listing fees gross revenue in 2002 was $320 million, but it is not possible to determine from the report precisely how much surplus was generated.

9.4 As a non-profit institution, the SFC charges regulatory fees on a "cost-recovery" basis. In other words, it would only seek to charge companies to fund the direct cost (and attributable overheads) of SMLR disclosure and transaction regulation. The SFC would need to determine with HKEx how fees for SMLR regulation and HKEx listing fees should be set following reform. The SFC believes that there will be flexibility to enable a range of solutions to be explored because it only charges fees on a cost-recovery basis, whilst HKEx listing fees generate surplus revenue.

9.5 Under the SFC's proposal HKEx will continue to be responsible for the Listing Rules that determine the types of companies it will accept for trading (e.g. entry criteria) as well as non-statutory governance and other rules. It is not envisaged that these Rules will require intensive day-to-day administration. There will need to be agreement on:

- fees charged by HKEx to listed companies for administration of the remaining Listing Rules; and

- additional fees for admission to and continued listing on HKEx.

The latter type of fee would be in the nature of a charge for access to the trading platform (rather than payment for regulation), or possibly a charge for other services provided by HKEx to listed companies. HKEx fees should be determined in accordance with the criteria set out in section 76 of the SFO which refers, among other things, to the levels imposed by exchanges outside Hong Kong.

9.6 Because the SFC finances regulatory work on a cost-recovery basis it is anticipated that overall fees charged to listed companies by HKEx and the SFC following reform should not increase beyond their existing levels.

10. Listing Sponsors

10.1 In May 2003 HKEx and the SFC issued a Consultation Paper on the Regulation of Sponsors and Independent Financial Advisers. The paper recognises that the sponsors' role is of special importance in Hong Kong, due to an unusually large portion of listed companies whose domicile and main operations are located outside the jurisdiction – particularly in Mainland China. Verifying information for Mainland-based private sector companies presents particular challenges, and special reliance is placed on the judgement and due diligence work of sponsors who bring companies to the market.

10.2 Among other things, the May consultation paper proposed a regime administered by HKEx to establish the acceptability of corporate finance advisers who wish to act as sponsors or independent financial advisers to prospective listing applicants or listed companies. The paper also proposed that there should be regulatory guidance to further clarify the responsibilities of sponsors and independent financial advisers.

10.3 The proposals would introduce to the Exchange's Main Board criteria for eligibility for sponsors which would be similar to those now applicable to GEM sponsors. The criteria would include tests of competence and experience.

10.4 Sponsors and independent financial advisers, together with their relevant professional staff, must also be licensed by the SFC under Part V of the SFO for "Type 6" regulated activity – advising on corporate finance. They must demonstrate to the SFC that they are "fit and proper" in order to be granted a licence. In considering fitness and properness the SFC will have regard to various factors, including qualifications and experience. The SFC has also issued a Code (the "Corporate Finance Adviser Code of Conduct") which is used as benchmark, together with other SFC codes and guidelines, against which corporate finance advisers' continuing fitness and properness is measured.

10.5 The May consultation paper recognised that the proposals for sponsors' registration with HKEx would involve the operation of parallel qualification and registration regimes – one at HKEx and the other administered by the SFC under the SFO. However, the paper expressed the view of HKEx that

"*Registration serves to reinforce the necessary nexus, or linkage, between … intermediaries and [the Exchange] as market regulator … as the Exchange relies directly on the work performed by sponsors, it is only appropriate that the Exchange has the final say in determining who should be permitted to perform that work, what the standards of performance should be, and importantly, how to address poor performance by sponsors*."

10.6 Responses to the May consultation paper reflected widespread concern on the part of financial intermediaries that they should not be subject to a system involving two layers of regulation and registration administered by two organisations – HKEx and the SFC – covering the same type of conduct. Strong views were expressed that any enhanced standards applicable to sponsors and independent financial advisers should all be contained within the SFC's licensing regime.

10.7 These consultation responses highlight an important aspect of problems described earlier in this paper which stem from the horizontal division of responsibility for the regulation of listed companies between HKEx and the SFC. Arguments for a single regulatory regime for sponsors and independent financial advisers administered by the SFC (which alone has statutory powers over intermediaries under the SFO) are compelling. However, because HKEx currently operates as the front-line regulator for listed companies (and in particular as disclosure regulator) it has principal day-to-day contact with sponsors when vetting prospectuses and listing documents. This could impact on the effectiveness of a single regulatory regime. Nevertheless respondents considered that even under the current system of listing regulation the best solution would be to ensure that sponsors and independent financial advisers are subject to a single regime.

10.8 Market concerns about "double regulation" would be resolved following implementation of the proposals in this response. Inclusion of a detailed

disclosure regime for listed companies in the SMLR will mean that a principal point of day-to-day contact for listing sponsors in an IPO will be with the SFC as statutory disclosure regulator. The SFC will thereby be able to operate as an effective single regulator of sponsors under the licensing provisions of Part V of the SFO.

11. Co-operation with Mainland China Regulators

11.1 Structural weaknesses in the Hong Kong regulatory regime and HKEx's perceived conflicts of interest are likely to be increasingly problematic as our market continues to mature and develop. As we continue to attract more Mainland China enterprises, state-owned as well as private, to come to our market, special demands will be placed on our regulatory regime. It is more difficult in cross-border markets for regulators to collect and evaluate information. More reliance is put on professional intermediaries as gatekeepers, and on regulatory counterparts for assistance.

11.2 For companies and company management that have little presence in Hong Kong other than a listing status, the reputational sanctions (public censures and criticisms) which are in practice available to HKEx do not provide meaningful deterrence. Indeed, for those who have sold their holdings and ceased to be company directors, HKEx cannot even ask them for information or subject them to sanctions. Serious regulation depends on credible enforcement.

11.3 Regulation of Mainland China enterprises is now key to the Hong Kong market, as they account for a substantial portion of our total market capitalization, new listings in number, and amount of funds raised. Mainland authorities have encouraged listing of state-owned as well as private enterprises in Hong Kong so that these firms can operate in a regulatory environment of international standing, improving their corporate governance and, ultimately, their competitiveness.

11.4 Experience has shown that Mainland China enterprises can be very entrepreneurial. Yet they can also have problems operating in an environment where the commercial infrastructure is still evolving. Privately-owned businesses are often high-growth, high-risk, and much hinges on the degree of discipline of company management and their advisers. Whether Hong Kong is able to deliver meaningful regulation will in large part determine whether these enterprises help take the Hong Kong market to its next stage.

11.5 In this regard, regulatory co-operation with the Mainland China authorities is critical. Mainland China has a statutory regime for the regulation of public offerings and of public companies, with the China Securities Regulatory Commission ("CSRC") as the primary regulator.

11.6 Within the formal framework for liaison under the 1993 Memorandum of Regulatory Co-operation, the CSRC and the SFC, as statutory counterparts, have the leading roles. The two Commissions are responsible for setting the agenda and conduct most of the discussion. At the semi-annual MORC meetings, the two Commissions also hold enforcement meetings.

11.7 The two Commissions have a number of other informal working groups and regular contacts on the full range of regulatory matters, e.g., takeovers, funds, intermediaries supervision, licensing, enforcement etc. In light of its Dual Filing responsibilities, the SFC is in frequent communications with the CSRC on potentially problematic cases and policy issues. In addition, the two Commissions have numerous staff exchanges to work on cross-border regulatory co-operation, particularly in enforcement.

11.8 Only through frequent contacts and joint efforts can the two regulators better understand each other's operating environment and cooperate more effectively. Clear lines of communications and responsibilities are vital. It is necessary that colleagues on both sides are comfortable to discuss matters as they arise by telephone or at ad hoc meetings.

11.9 It is easier for statutory regulators to share confidential information and have early communications. It is natural for one statutory agency to be more comfortable providing confidential information to another, particularly when the other is subject to statutory confidentiality obligations as well as other checks and balances, and is a member of the same umbrella international organisation (in this case IOSCO). Mutual trust is built through contacts at many different points of regulatory co-operation.

11.10 For Mainland China to continue to encourage its enterprises to come to the Hong Kong market, it is entitled to an assurance that there will be a statutory Hong Kong regulator with clear responsibility over those aspects of regulation that, broadly, the CSRC is also responsible for in the Mainland, proper powers, and the ability to operate effective channels of communication for efficient mutual co-operation. The proposals for reform detailed in this response would enable this assurance to be given without reservation.

Appendix I – Comparison of the Present Hong Kong Rules and Their US Equivalents

Subject Matter	Hong Kong Rules[1]	US – Statutory SEC Rules	US – Non-statutory NYSE Rules
Prospectuses - Registration - Substantive content	CO 38D, 342C LR App. 1; more detail than CO 3rd Schedule	SA 5, 10 Reg. SK with Forms S1 to S4, Reg. SX	LCM 702.04 requires SEC-registered prospectus none
Annual and Periodic Reports - Publication - Substantive content	LA 8; CO does not apply in most cases LR App. 16	SEA 13 Rules 13a-1, 13a.13 with Forms 10K, 10Q	LCM 203.01, 203.02 none
Financial Statements - Substantive content	LR App. 16	Reg. SX	none
Connected Transactions[2] - Circular and approval - Substantive content	LA 3, LR 14.24 to 14.26 LR 14.30	none none	none none
Major Trans., VSAs, VSDs - Circular and approval - Substantive content	LA 3, LR 14.07, 14.08, 14.10, 14.11 LR 14.16, 14.17	Rule 13a-11, Form 8K Item 2 (see below) Rule 13a-11, Form 8K (not detailed as in HK)	LCM 204.06, 204.15 (notifies NYSE) none
Other Discloseable Trans. - Circular - Substantive content	LA 3, LR 14.13 LR 14.16, 14.17	none none	none none
Price Sensitive Information - General disclosure - Fair disclosure	LA 2 and 39, Guide on Disclosure none	threat of Rule 10b-5 or insider dealing liability Reg. FD	LCM 202.05, 202.06 none

[1] Excluding the general "not false or misleading" requirement.
[2] The US legal framework exerts (tough) controls on connected transactions as "self dealing" through corporate law and litigation rather than securities regulation.

Subject Matter	Hong Kong Rules[1]	US – Statutory SEC Rules	US – Non-statutory NYSE Rules
Miscellaneous Events			
- Change in control	as VSAs (see above)	Rule 13a-11, Form 8K Item 1	LCM 204.11 (relies on SEC filings)
- Acquire/dispose sig. assets	as major transactions, VSAs, VSDs (see above)	Rule 13a-11, Form 8K Item 2 (not in ord. course)	LCM 204.15 (if materially affects financial pos.)
- Bankruptcy or receivership	LA 17	Rule 13a-11, Form 8K Item 3	LCM 204.21 (notifies NYSE)
- Change in auditors	LA 14	Rule 13a-11, Form 8K Item 4	LCM 204.05 (notifies NYSE)
- Resignation of director	LA Note 14.2	Rule 13a-11, Form 8K Item 6	LCM 204.14 (notifies NYSE)
- Change in fiscal year	none	Rule 13a-11, Form 8K Item 8	none
- Material contract	LR App. 16 P15, 16 (disclosure in annual report)	proposed new Form 8K	none
- Termination of material con.	none	proposed new Form 8K	none
- Loss of sig. customer	none	proposed new Form 8K	none
- Sig. financial obligation	none	proposed new Form 8K	none
- Material write-offs or restrut.	none	proposed new Form 8K	none
- Material impairment	none	proposed new Form 8K	none
- Change in rating	none	proposed new Form 8K	none
- Delisting or change in listing	LR 6.10, LA 18	proposed new Form 8K	LCM 802.02
- Accounts no longer reliable	none	proposed new Form 8K	none
- Limitation in benefits plans	none	proposed new Form 8K	none
- Change to rights of S/Hs	LA 14	proposed new Form 8K	LCM 204.17, 204.31 (notifies NYSE)
- Change to articles or bylaws	LA 14, 20	proposed new Form 8K	LCM 204.03 (notifies NYSE)
Tender/exchange offers			
- Conducting the offer	Takeovers Code	SEA 13, 14	none
- Disclosure content	Takeovers Code	Reg. 14D, Schedule 14D-I, Reg. SK, Reg. SX	none
Repurchase (not GO)[3]			
- Restrictions	LR 10.06 (general mandate with S/Hs approval)	Rule 10b-18	none
- Disclosure	LA 16 (notifies the Exchange)	Reg. SK Item 703 (proposed for periodic reports)	LCM 204.33 (notifies NYSE quarterly)
General Mandate			
- % restriction	LA 19 (S/Hs approval for issuance >20%)	none	LCM 312.03 (S/Hs approval for issuance >20%)

[3] US law allows treasury stock; Hong Kong law does not.

Subject Matter	Hong Kong Rules[1]	US – Statutory SEC Rules	US – Non-statutory NYSE Rules
Share Options Scheme			
- Disclosure at IPO	LR 17.02	Reg. SK Item 402	none
- Restrictions	LR 17.03	none	none
- S/Hs' approval	LR 17.02	none	LCM 312.03
- Disclosure content	LR 17.02	Reg. 14A, Schedule 14A (for all proxy statements)	none
Entry Criteria			
- Track record	LR 8.05	none	LCM 102.01, 103.01
- Market cap.	LR 8.09	none	LCM 102.01, 103.01
- Public float, # of S/Hs etc.	LR 8.08	none	LCM 102.01, 103.01
Exit Criteria			
- Objective criteria	none	none	LCM 802.01 (mkt. cap., # of S/Hs, min. price etc.)
- Sufficiency of operations	LA 38, LR PN 17	none	LCM 802.01 (reduction in operations)
Directors' Securities Trans.			
- Restrictions	LR App. 10 (1-month blackout before results)	SEA 16 (6-month short-swing profit rule)	none
Corporate Governance			
- Code of Best Practice	LR App. 14	none	proposed NYSE guidelines
- Disclosure on compliance	LR App. 16 P34, 44	Reg. SK, Rule 13a-11, Form 8K, Form 10K	proposed NYSE guidelines

Abbreviations

CO = Companies Ordinance
LR = Listing Rules
LA = Listing Agreement
SA = Securities Act of 1933
SEA = Securities Act of 1934
LCM = Listed Company Manual

Cap. 571V

SECURITIES AND FUTURES (STOCK MARKET LISTING) RULES

Empowering section: Cap 571, section 36(1)

Version Date: 01/04/2003

PART 1

PRELIMINARY

1. (Omitted as spent)

2. Interpretation

In these Rules, unless the context otherwise requires-

"applicant" (**申請人**) means a corporation or other body which has submitted an application under section 3;

"application" (**申請**) means an application submitted under section 3 and all documents in support of or in connection with the application including any replacement of and amendment and supplement to the application;

"approved share registrar" (**認可股份登記員**) means a share registrar who is a member of an association of persons approved by the Commission under section 12;

"issuer" (**發行人**) means a corporation or other body the securities of which are listed, or proposed to be listed, on a recognized stock market;

"share registrar" (**股份登記員**) means any person who maintains in Hong Kong the register of members of a corporation the securities of which are listed, or proposed to be listed, on a recognized stock market.

PART 2

STOCK MARKET LISTING

3. Requirements for listing applications

An application for the listing of any securities issued or to be issued by the applicant shall-

(a) comply with the rules and requirements of the recognized exchange company to which the application is submitted (except to the extent that compliance is waived or not required by the recognized exchange company);

(b) comply with any provision of law applicable; and

(c) contain such particulars and information which, having regard to the particular nature of the applicant and the securities, is necessary to enable an investor to make an informed assessment of the activities, assets and liabilities and financial position, of the applicant at the time of the application and its profits and losses and of the rights attaching to the securities.

4. Exemptions from sections 3 and 5

Sections 3 and 5 do not apply to the listing of any-

(a) securities issued or allotted-

(i) by a capitalization issue pro rata (apart from fractional entitlements) to existing shareholders, whether or not they are shareholders whose addresses registered in the books of the corporation are in a place outside Hong Kong and to whom the securities are not actually issued or allotted because of restrictions imposed by legislation of that place; or

(ii) pursuant to a scrip dividend scheme which has been approved by the corporation in general meeting;

(b) securities offered on a pre-emptive basis, pro rata (apart from fractional entitlements) to existing holdings, to holders of the relevant class of shares in the corporation, whether or not they are shareholders whose addresses registered in the books of the corporation are in a place outside Hong Kong and to whom the securities are not actually offered because of restrictions imposed by legislation of that place;

(c) shares issued in substitution for shares listed on a recognized stock market, if the issue of the shares does not involve any increase in the issued share capital of the corporation;

(d) shares issued or allotted pursuant to the exercise of options granted to existing employees as part of their remuneration under a scheme approved by the shareholders of the corporation in a general meeting.

5. Copy of application to be filed with the Commission

(1) An applicant shall file a copy of its application with the Commission within one business day after the day on which the application is submitted to a recognized exchange company.

(2) An applicant is regarded as having complied with subsection (1) on the day it submits the application to a recognized exchange company if, prior to or at the time of submitting the application to the recognized exchange company, the applicant has authorized the recognized exchange company in writing to file the application with the Commission on its behalf.

6. Powers of the Commission to require further information and to object to listing

(1) Subject to subsection (8), the Commission may, by notice to an applicant and a recognized exchange company given within 10 business days from the date the applicant files a copy of its application with the Commission (or if there is more than one such date, the latest date), require the applicant to supply to the Commission such further information as the Commission may reasonably require for the performance of its functions under these Rules.

(2) The Commission may, within the period specified in subsection (6), by notice to an applicant and a recognized exchange company, object to a listing of any securities to which an application relates if it appears to the Commission that-

(a) the application does not comply with a requirement under section 3;

(b) the application is false or misleading as to a material fact or is false or misleading through the omission of a material fact;

(c) the applicant has failed to comply with a requirement under subsection (1) or, in purported compliance with the requirement has furnished the Commission with information which is false or misleading in any material particular; or

(d) it would not be in the interest of the investing public or in the public interest for the securities to be listed.

(3) The Commission may, within the period specified in subsection (6), notify an applicant and a recognized exchange company that-

(a) it does not object to the listing of any securities to which an application relates; or

(b) it does not object to the listing of any securities to which an application relates subject to such conditions as the Commission may think fit to impose.

(4) A recognized exchange company may list the securities to which an application relates only if-

(a) the Commission has not, within the period specified in subsection (6), given a notice in relation to the application under subsection (2) or (3)(b);

(b) the Commission has given a notice in relation to the application under subsection (3)(a); or

(c) the conditions referred to in subsection (3)(b) in relation to the application have been complied with.

(5) Where the Commission objects to a listing under subsection (2) or imposes any condition under subsection (3)(b), the objection or imposition shall take effect immediately.

(6) The period specified for the purposes of subsections (2), (3) and (4) is 10 business days-

(a) where the Commission has not given a notice under subsection (1) in relation to the application, from the date the applicant files a copy of the application with the Commission (or if there is more than one such date, the latest date); or

(b) where the Commission has given a notice under subsection (1) in relation to the application, from the date when the further information is supplied.

(7) A notice given under subsection (2) shall be accompanied by a statement specifying the reasons for the objection.

(8) The Commission shall not give any notice to an applicant under subsection (1) after-

(a) it has given a notice in relation to the application under subsection (3)(a); or

(b) the conditions referred to in subsection (3)(b) in relation to the application have been complied with.

7. Copy of ongoing disclosure materials to be filed with the Commission

(1) An issuer shall file with the Commission a copy of any announcement, statement, circular, or other document made or issued by it or on its behalf to the public or to a group of persons comprising members of the public (including its shareholders)-

(a) under the rules and requirements of a recognized exchange company or any provision of law applicable; or

(b) pursuant to the terms of any listing agreeme nt between the issuer and a recognized exchange company under the rules of the recognized exchange company,

within one business day following the day on which such announcement, statement, circular or other document is made or issued.

(2) A person shall file with the Commission a copy of any announcement, statement, circular or other document made or issued by the person or on his behalf to the public or to a group of persons comprising members of the public (including holders of the securities of an issuer) under any codes published by the Commission under section 399(2)(a) and (b) of the Ordinance within one business day following the day on which such announcement, statement, circular or other document is made or issued.

(3) An issuer or a person is regarded as having complied with subsection (1) or (2) if the issuer or the person has-

(a) filed with the recognized exchange company concerned; and

(b) authorized the recognized exchange company in writing to file with the Commission on behalf of the issuer or the person, as the case may be,

a copy of the relevant announcement, statement, circular or other document.

PART 3

SUSPENSION OF DEALINGS

8. Suspension of dealings in securities

(1) Where it appears to the Commission that-

(a) any materially false, incomplete or misleading information has been included in any-

(i) document (including but not limited to any prospectus, circular, introduction document and document containing proposals for an arrangement or reconstruction of a corporation) issued in connection with a listing of securities on a recognized stock market; or

(ii) announcement, statement, circular or other document made or issued by or on behalf of an issuer in connection with its affairs;

(b) it is necessary or expedient in the interest of maintaining an orderly and fair market in securities traded through the facilities of a recognized exchange company on the recognized stock market it operates;

(c) it is in the interest of the investing public or in the public interest, or it is appropriate for the protection of investors generally or for the protection of investors in any securities listed on a recognized stock market; or

(d) there has been a failure to comply with any condition imposed by the Commission under section 9(3)(c),

the Commission may, by notice to the recognized exchange company, direct the recognized exchange company to suspend all dealings in any securities specified in the notice.

(2) The recognized exchange company shall comply with any notice given under subsection (1) without delay.

9. Powers of the Commission upon the suspension under this Part of dealings in any securities

(1) An issuer which is aggrieved by a direction given by the Commission under section 8 may make representations in writing to the Commission and where an issuer makes such representations, the Commission shall notify the recognized exchange company.

(2) In respect of a direction given by the Commission under section 8, the recognized exchange company may make representations in writing to the Commission irrespective of whether representations in respect of that direction have been made by an issuer under subsection (1) and where the recognized exchange company makes such representations, the Commission shall notify the issuer.

(3) Where the Commission has-

(a) directed a recognized exchange company to suspend dealings in any securities under section 8(1); and

(b) considered any-

(i) representations made by the issuer under subsection (1);

(ii) representations made by the recognized exchange company under subsection (2); and

(iii) further representations made by the issuer or the recognized exchange company,

the Commission may, by notice to the recognized exchange company-

(c) permit dealings in the securities to recommence subject to such conditions as the Commission may think fit to impose, being conditions of the nature specified in subsection (4); or

(d) direct the recognized exchange company to cancel the listing of the securities on a recognized stock market operated by it if the Commission-

(i) is satisfied that there has been a failure to comply with any requirement in respect of listing set out in these Rules or in any other rules made under section 36 of the Ordinance; or

(ii) considers that the cancellation of the listing is necessary to maintain an orderly market in Hong Kong,

and the recognized exchange company shall comply with the direction without delay.

(4) The conditions which may be imposed under subsection (3)(c) are-

(a) where the Commission has given a direction under section 8(1)(a) or (d), conditions imposed with the object of ensuring, so far as is reasonably practicable, that the issuer remedies the default by reason of which the suspension of dealings was directed;

(b) where the Commission has given a direction under section 8(1)(b), such conditions as the Commission may consider necessary or expedient in the interest of maintaining an orderly and fair market in securities traded through the facilities of the recognized exchange company mentioned in that section;

(c) where the Commission has given a direction under section 8(1)(c), such conditions as the Commission may consider to be in the interest of the investing public or in the public interest, or to be appropriate for the protection of investors generally or for the protection of the investors mentioned in that section.

(5) In subsection (3), "further representations" (**進一步申述**) means representations either in writing or orally or both in writing and orally as the issuer or the recognized exchange company may determine which are submitted within such reasonable time as the Commission may determine.

(6) The powers of the Commission under this section may only be exercised by a meeting of the Commission and are not delegable.

(7) A member of the Commission who made the decision in the exercise of the Commission's powers under section 8 shall not participate in the deliberations or voting of the Commission in the performance of its functions under this section as regards that exercise of the Commission's powers.

(8) Notwithstanding subsection (7), the member of the Commission referred to in that subsection may attend any meeting or proceeding of the Commission in the performance of its functions under this section as regards the exercise of the Commission's powers under section 8 and may make such explanations of his decision as he thinks necessary.

10. Provisions supplementary to sections 8 and 9

(1) At any hearing held by the Commission to receive oral representations made to it under section 9(3)(b)(iii), the issuer and the recognized exchange company each have the right to be represented by its counsel or solicitor.

(2) If representations are made under section 9(1) or (2) against a direction made under section 8(1) then, pending the decision of the Commission under section 9(3), all dealings in the securities concerned shall remain suspended.

11. Restriction on re-listing

No security the listing of which has been cancelled under section 9(3)(d) shall be listed again on a recognized stock market except in accordance with Part 2.

PART 4

APPROVED SHARE REGISTRARS

12. Approval of share registrars

(1) The Commission may approve an association of persons as an association each of whose members shall be an approved share registrar for the purposes of these Rules.

(2) The Commission may cancel the approval of any association of persons approved under subsection (1).

(3) The Commission shall maintain a list of associations of persons approved under subsection (1).

13. Securities not to be listed where approved share registrar not employed

No application made by a corporation to a recognized exchange company for the listing of any securities issued or to be issued by that applicant shall be approved by the recognized exchange company unless the applicant is an approved share registrar or employs an approved share registrar as its share registrar.

14. Suspension of dealings on cessation of employment, etc. of approved share registrar

(1) Where-

(a) the securities of a corporation are listed on a recognized stock market; and

(b) the corporation ceases either to be an approved share registrar or to employ an approved share registrar as its share registrar,

the recognized exchange company shall give the corporation a notice of its intention to suspend dealings in the securities of the corporation unless, before the date specified in the notice, being 3 months after the date on which the recognized exchange company first learned of such cessation or 21 days from the date of the notice, whichever is the later, the corporation becomes an approved share registrar or employs an approved share registrar as its share registrar.

(2) Where the corporation fails to comply with the requirement stated in the notice given under subsection (1), the recognized exchange company shall suspend dealings in the securities of the corporation.

(3) The Commission may require a recognized exchange company to give notice under subsection (1) to a corporation which has ceased either to be an approved share registrar or to employ an approved share registrar as its share registrar if, in the opinion of the Commission, the recognized exchange company has failed or neglected to do so within a reasonable time, and the recognized exchange company shall comply with the requirement without delay.

(4) A recognized exchange company which has suspended dealings in the securities of any corporation under subsection (2) shall permit the recommencement of dealings in those securities when it is satisfied that the corporation has become an approved share registrar or has employed an approved share registrar as its share registrar.

15. Power to exempt

(1) The Commission may exempt all or any particular class of securities issued by a corporation specified in a notice under subsection (2) from all or any of the provisions of this Part.

(2) An exemption granted under subsection (1) shall be notified by the Commission to the corporation specified in the notice and to the recognized exchange company which operates the recognized stock market on which the exempted class of securities is, or is proposed to be, listed.

(3) The Commission may withdraw any exemption granted under subsection (1), and the withdrawal shall be notified in the same manner as an exemption is required to be notified under subsection (2).

(4) Where an exemption in respect of any securities of a corporation has been withdrawn under subsection (3), the recognized exchange company shall suspend dealings in those securities unless-

(a) at the date of notification of the withdrawal, the corporation is an approved share registrar or employs an approved share registrar as its share registrar; or

(b) within 3 months after the date of notification of the withdrawal, the corporation becomes an approved share registrar or employs an approved share registrar as its share registrar.

16. Appeal against suspension

(1) Where a recognized exchange company suspends dealings in the securities of a corporation under section 14 or 15(4) the corporation may, within 21 days of the suspension, appeal in writing to the Commission against the suspension.

(2) An appeal under subsection (1) shall be accompanied by such submissions in writing as the corporation wishes to make.

(3) On any appeal under subsection (1), the Commission may-

(a) dismiss the appeal;

(b) direct the recognized exchange company to permit the recommencement of dealings in the securities; or

(c) direct the recognized exchange company to permit the recommencement of dealings in the securities subject to such conditions as the Commission thinks fit.

PART 5

MISCELLANEOUS

17. Waiver of requirements of Parts 2 and 3

The Commission may, by notice to an applicant or an issuer and a recognized exchange company, modify or waive, subject to such reasonable conditions as the Commission may think fit to impose, any requirement of Parts 2 and 3 where the Commission is of the opinion that-

(a) the applicant or issuer, as the case may be, cannot comply with the requirement or it would be unreasonable or unduly burdensome for the applicant or issuer to do so;

(b) the requirement has no relevance to the circumstances of the applicant or issuer, as the case may be; or

(c) compliance with the requirement would be detrimental to the commercial interests of the applicant or issuer, as the case may be, or to the interests of the holders of its securities.

18. Suspensions, etc. by a recognized exchange company to be notified to the Commission

(1) If a recognized exchange company intends to suspend dealings in any securities it shall, where reasonably practicable, inform the Commission of its intention prior to such suspension or, if not so practicable, inform the Commission of the suspension as soon as possible after the suspension.

(2) If a recognized exchange company, after having suspended dealings in any securities, intends to permit dealings in the securities to recommence, it shall, where reasonably practicable, inform the Commission of its intention to permit dealings to recommence or, if not so practicable, inform the Commission as soon as possible after permitting dealings to recommence.

(3) A recognized exchange company shall not cancel the listing of any securities unless it gives the Commission at least 48 hours' notice of its intention to do so.

(4) This section applies only to the suspension of dealings in any securities or the cancellation of dealings in any securities by a recognized exchange company other than in accordance with a direction of the Commission under section 8 or 9.

19. Notices, etc. to be in writing

Any notice or direction under these Rules shall be in writing.

20. Transitional

(1) Where-

(a) before the commencement of these Rules, any power could have been, but was not, exercised under rule 9 or 10 of the Securities (Stock Exchange Listing) Rules (Cap 333 sub. leg. C) which has been repealed under section 406 of the Ordinance ("the repealed Rules"); or

(b) before such commencement any power has been exercised under any provision referred to in paragraph (a), and the exercise of the power would, but for the commencement, continue to have force and effect on or after such commencement,

then-

(c) (i) where paragraph (a) applies, the power may be exercised; or

(ii) where paragraph (b) applies, the exercise of the power shall continue to have force and effect,

as if the repealed Rules had not been repealed; and

(d) the provisions of the repealed Rules shall continue to apply to the exercise of the power and to any matters relating thereto (including any right to make representations in respect of the exercise of the power under rule 9) as if the repealed Rules had not been repealed.

(2) Subject to subsection (3), where before the commencement of these Rules, an application is made under rule 3 of the repealed Rules and immediately before such commencement the application has not been approved, refused or withdrawn, the application shall upon such commencement be treated as an application under section 3 and the provisions of these Rules (except section 3) shall apply accordingly.

(3) Section 5 shall apply only to any part of an application submitted on or after the commencement of these Rules.

Appendix III – Disclosure Requirements to be Given Statutory Backing

The table below sets out the disclosure requirements currently in the Listing Rules that should be given statutory backing and be administered by the statutory regulator. A separate table at Appendix IV sets out the requirements currently in the Listing Rules that should remain without statutory backing and be administered by the Stock Exchange. In arriving at these tables, we have considered:

(i) The right of public investors to full, accurate, and timely information;
(ii) The need to enhance investor protection by strengthening the enforceability of disclosure requirements;
(iii) The regulatory requirements of leading jurisdictions overseas, in particular the United States; and
(iv) The categories of rules that HKEx has itself put forward as needing statutory backing.

REF.	**DISCLOSURE REQUIREMENT**
I.	***Prospectuses and Listing Documents***
	General Requirements
9.11-16, App.5	Documents to be submitted, number of copies, and timing
Ch.11&11A	Listing documents and prospectuses – general requirements and guidance
Ch.12, App.11	Publication of notices relating to the listing
	Substantive Requirements
App.1	Content of listing documents
4.01	Inclusion of accountants' reports
5.01	Inclusion of valuation reports (subject to exclusion allowed by PN16)
8.10(1)(a)&(2)	Competing businesses of controlling shareholders and directors
8.21	Change in financial year immediately prior to listing
11.16-11.19	Profit forecasts
7.19(2)-(4)	Specific items of disclosure for rights issues
7.24(2)-(3)	Specific items of disclosure for open offers

19.08-10, 23	Modifications for overseas incorporated companies (including requirements in App.13a/b Sec.3)
19A.28-29, 37-41	Modifications for PRC-incorporated companies (including requirements in App.13d Sec.2)
19.29-31, 36-39, 45	Modifications for secondary listing of overseas incorporated companies (including requirements in App.13a/b Sec.3)
II.	***Annual and Periodic Reports***
LA8-10	Annual and interim reports
LA11	Preliminary announcements of results
Ch.4, App.16	Content of reports and announcements
PN10	Interim reporting by newly listed companies – general guidance
19.15-19	Modifications for overseas incorporated companies
19A.08-11	Modifications for PRC-incorporated companies
App.15	Additional requirements for banks
17.07-09	Disclosure on share options
III.	***Financial Statements***
App.16	Content and presentation of financial statements in listing documents, reports, and announcements
IV.	***Notifiable Transactions***
	Preliminary and Interpretation
14.01-05, 37-40	Definitions to determine connectedness, provisions on aggregation of transactions etc.
	Categorization and Consequential Disclosure (including the requirement for shareholders' approval)
14.06-08	VSA (see Note 1)
14.09-11	Major Transactions
14.12-19	Discloseable Transactions
14.20-22	Share Transactions
14.23, 25-32	Connected Transactions
14.24	Waivers from connected transaction rules

PN13 Sec.1-4	Determination of notifiable transactions – general guidance
4.01(3)	Inclusion of accountants' reports in circulars to shareholders
5.02-03	Inclusion of valuation reports (subject to exclusion allowed by PN16)
19A.34	Modifications for PRC-incorporated companies
V.	***Price-Sensitive Information***
LA2, PN19	Disclosure of PSI
LA39	Clarification announcements upon unusual price/volume movement
Blue booklet	Disclosure of PSI – general guidance
VI.	***Miscellaneous***
	Specific Events
LA14	Announcement upon change in auditors
LA Note14.2	Announcement upon appointment or resignation of a director
LA14	Announcement upon change to rights of shareholders
LA14, 20	Announcement upon change to articles or bylaws
LA17	Announcement upon bankruptcy, receivership, or possession/sale of assets > 15% of NTA
PN13 Sec.2.3, 5	Determination of dilution of interests in subsidiaries for LA17 – general guidance
17.02(2)-(3)	Circulars seeking shareholders' approval of share option schemes (see Note 2)
LA7	Announcement of issuances pursuant to general mandate (see Note 3)
	Valuations
Ch.5, PN12, PN16	Content requirements for valuation reports
	Disclosure of Interests
PN5	Disclosure of interests information – in listing documents, periodic reports, and generally
	General
1.01	Definitions
19A.04	Definitional modifications for PRC-incorporated companies

2.07, 9.03 etc.	Delivery of information and documents (in relation to electronic submissions, number of copies, language etc.)
Ch.3, 19A.05	Clarify that regulatory jurisdiction covers sponsors, company directors, and authorized reps
9.03	Sponsors should submit draft listing documents in advanced form
9.08	Pre-listing publicity materials
SMLR7&8	Preserve current provisions as "catch all"

Notes:

(1) Deeming certain types of VSAs "reverse takeovers" is an entry/exit matter, which should remain in the non-statutory Listing Rules. But the content of any consequential circulars and/or resumption proposals is a disclosure matter, which should be governed by the future equivalent to the present Appendix 1 of the Listing Rules. This is the approach under Dual Filing, which subjects all "listing applications" to SFC review.

(2) Any restrictions on a listed company's use of share options are matters of corporate governance and should remain in the non-statutory Listing Rules. But to the extent that a company has to send circulars to shareholders seeking their approval of share option schemes, it is a disclosure matter, which should be governed by statutorily backed disclosure requirements. In other words, the Exchange will set the restrictions on what option schemes and terms are acceptable, and the SFC will set the disclosure necessary for public shareholders.

(3) Any restrictions on a listed company's use of general mandate are matters of corporate governance and should main in the non-statutory Listing Rules, e.g., Listing Agreement paragraph 19. But the obligation for a company to inform its shareholders and the market of any issuances pursuant to the general mandate it has obtained from its shareholders is a disclosure matter, which should be governed by statutorily backed disclosure requirements.

(4) Generally, requirements of professionals providing confirmation letters could be cast as requirements for the company to state that it has obtained the letters and to state the content of the letters.

(5) For ease of understanding, we have focused on the Listing Rules on common equity securities (Chapters 7 to 14, 17, 19, and 19A). We have not dealt with derivatives (Chapters 15, 15A, and 16), mineral companies (Chapter 18), investment vehicles (Chapters 20 and 21) and debt securities (Chapters 22 to 37). But the same method of categorization is equally applicable.

Appendix IV – Non-Disclosure Requirements Without Statutory Backing

The table below sets out the non-disclosure requirements currently in the Listing Rules that should remain without statutory backing and be administered by the Stock Exchange. A separate table at Appendix III sets out the requirements currently in the Listing Rules that should be given statutory backing and be administered by the statutory regulator.

REF.	**NON-DISCLOSURE REQUIREMENT**
I.	***Entry – Listing Criteria and Mechanics***
	Qualifications for Listing
Ch.8	Basic conditions for listing (except 8.10(1)(a)&(2) on competing businesses and 8.21 on change in financial year)
PN3	Guidelines on adequate trading record under substantially the same management
PN15	Principles for spin-off applications
19.05, 25, 26	Additional requirements for primary listing and secondary listing of overseas issuers
19A.03, 13-21	Additional requirements and modifications for PRC issuers
	Methods of Listing
Ch.7	Explanations and requirements of each method of listing (see Note 1)
App.6	Placing guidelines for equity securities
10.01, 10.02 & PN20	Restrictions on preferential treatment of purchase and subscription applications for employees/ex-employees in a listing
10.03	Restrictions on directors' purchase and subscription of securities in a listing
10.04	Restrictions on existing shareholders' purchase and subscription of securities in a listing
10.08(1), (2) &(3)	Restrictions on multiple applications in a listing
	Application Procedures and Requirements
9.01-10, PN6	Procedures and requirements for applications for listing of equity securities (by new applicants or listed issuers)
PN18	Procedures for allocation of shares in an IPO; procedures for an IPO involving placing and public subscription
19.06-07, 27-28	Modifications for primary listing and secondary listing of overseas issuers
19A.22-24	Modifications for PRC issuers

II.	***Fees***
2.12, 19.21&43, 19A.35	General reference to relevant sections
App.8	Initial listing fee, annual listing fee, subsequent issue fee, transaction levy, trading fee, teletext charges, brokerage etc.
III.	***Exit – Continuing Criteria and Delisting***
	Qualification for Continuing Listing
6.01, 10	Circumstances leading to cancellation of listing; process of cancellation of listing (see Note 2)
LA38, PN 17	Sufficiency of operations; procedures for delisting
14.35-36	Cash companies (suspension of listing until issuer has a business suitable for listing)
14.41-42	No transactions resulting in fundamental change within 12 months of listing (unless waiver)
LA18	Minimum public float
	Voluntary Delisting
6.11-12	Conditions for voluntary delisting
19A.12	Modifications for PRC issuers
IV.	***Corporate Governance***
	Directors, Board Practices, and Shareholders' Meetings
3.08-16, LA43-44, 19A.07A	Directors – requirements, qualifications, duties, obligations, and contact information
LA33	Directors' service contracts
App.14	Code of best practice for listed issuers
LA35	Proxy forms
LA36	Notices to shareholders
LA37	Equality of treatment of shareholders
LA40	Voting and soliciting votes at general meeting
	Restriction on dealing
10.07	Restrictions on disposal of shares by controlling shareholders following a new listing
LA32, App.10	Model code for directors' dealing in securities

	Share Issuances
LA34	Further issued same-class securities must be listed
LA19	Pre-emptive rights; shareholders' approval of issuances except pro-rata allotment and general mandate (see Note 3)
LA23	Proposal for increase in authorized capital to be accompanied by statement of present intention to issue or not
LA16(1) (App.7i for PRC issuers)	Not to issue any redeemable share without SEHK's approval
LA44-49 (App.7i for PRC issuers)	Additional requirements for PRC issuers
	Memorandum and Articles of Association
App.3, App.13, LA43	Mandatory requirements; additional requirements for issuers incorporated in Bermuda, Cayman Islands, and PRC
19A.42-45	Modifications for PRC issuers
	Share Option Schemes
17.01-05, 17.10, 19.41	Conditions and restrictions for granting share options (except 17.02(2)-(3) on circulars to shareholders; see Note 4)
	On-Market Repurchases
10.05-06, 19.20, 42	Restrictions, notification, and other requirements
19A.26-27	Modifications for PRC issuer
App.5 Form G	Form of share buyback report
V.	***Platform Operations***
	Suspension of Trading
6.01-09, PN11	Suspension and restoration of trading
	Trading and Settlement
App.2	Documents of title
LA24	Certification of transfers
LA25-28	Securities registration services, issue of certificate, and arrangement for designated accounts
PN8	Requirements relating to CASS; emergency share registration during typhoon and black rainstorm warning
LA30	Approaching trading limits of HK$0.01 or HK$9,995.00
LA31	Change in board lot size

	Communications with / Notification to SEHK
2.07C	Submission of corporate communication for publication by electronic means
PN1	Procedures on delivery of information and documents
LA21, 50 (App.7i for PRC issuers)	Forwarding documents, circulars etc. to SEHK; language requirement for PRC issuers
13.10	References to notifying SEHK under LA and Ch.14
2.11, 3.05-07, 10.06(6)(b)	Authorized representatives for communication with SEHK
19A.07	Authorized representatives of PRC issuer – must be readily contactable by SEHK if frequently outside HK
LA5	Notice to SEHK of closure of transfer books/register of members etc.
LA12	Advance notice to SEHK of any board meeting on dividend payment or announcement of profits/losses
LA13	Notice to SEHK after board decision on dividend, profits/losses, capital structure, or change in business
LA14(4)	Notice to SEHK of change in secretary, registered address, or agent for service of process
LA15	Notice to SEHK of basis of allotment of securities to public, results of rights issue, or acceptance of excess applications
LA16	Notice to SEHK after any purchase, sale, drawing or redemption of listed securities by the issuer or listed group
LA18	Notice to SEHK if insufficient public float or if securities are listed on another stock exchange
	Communication with / Notification to Shareholders
2.07A, B	Issuing corporate communication to shareholders – use of electronic means and choice of language
LA6	Newspaper notice of AGM
LA7	Newspaper announcement on issuances under general mandate
LA22	Forwarding circulars issued to holders of one type of securities to holders of all types; language requirement
LA22A	Forwarding corporate communications to non-registered shareholders upon request
19.22, 44, 19A.36	Certified English translation to accompany documents
VI.	***Sponsors***
2.09-10, 3.01-04, 9.02, App.9	Sponsors – requirement for, roles and responsibilities in a listing application; model code for sponsors
19A.05-06	Modifications and additional requirements for PRC issuers

VII.	***Listing Committee and Listing Division***
Ch.2A	Composition, powers, functions, and procedures
Ch.2B	Review procedures
VIII.	***Miscellaneous***
2.01-06, 08, 19.01-04, 24, 19A.01-02	Preliminary statements, general principles, and structure of the Listing Rules
13.01-05, 07, 09, 19.11, 32, 19A.30	Preliminary statements, general principles, and different forms of LA
1.01-07, LA 1, 19A.04	Definitions and interpretation (1.01 and 19.04 also in Disclosure Requirements Table)
App.12	Reproduction of SMLR
LA20A	Authorisation to SEHK to file listing applications and corporate disclosure materials with SFC
13.06, LA 41(1), 19.13, 34, 19A.32	SEHK' s general right to require publication of further information and impose additional requirements
13.08, LA41(2), 19.12, 33, 19A.31	SEHK' s general right to revise/modify LA (subject to SFC' s consent)
19.46	Overseas issuers with secondary listing – additional requirements where majority of trading likely to be on SEHK
LA42	Governing law of LA

Notes:

(1) Listing Rules 17.19(2)-(4) and 17.24(2)-(3) requires specific items of disclosure in listing documents for rights issues and open offers. These requirements should be included in the statutorily backed future equivalent to Appendix 1 of the Listing Rules on disclosure in listing documents.

(2) Proposals to remedy the matters that have rendered an issuer unsuitable for listing will be treated as a new application for listing. The content of the listing documents will be a disclosure matter, which should be governed by the future equivalent to Appendix 1 of the Listing Rules. This is the approach under Dual Filing, which subjects all "listing applications" to SFC review.

(3) Any restrictions on a listed company's use of general mandate are matters of corporate governance and should main in the non-statutory Listing Rules. But the obligation for a company to inform its shareholders and the market of issuances pursuant to the general mandate, e.g., as required under Listing Agreement paragraph 7, is a disclosure matter, which should be governed by statutorily backed disclosure requirements.

(4) Any restrictions on a listed company's use of share options are matters of corporate governance and should remain in the non-statutory Listing Rules. But to the extent that a company has to send circulars to shareholders seeking their approval of share option schemes, it is a disclosure matter, which should be governed by statutorily backed disclosure requirements. In other words, the Exchange will set the restrictions on what option schemes and terms are acceptable, and the SFC will set the disclosure necessary for public shareholders.

Financial Services and Markets Act 2000
Part VI
Official Listing - Penalties

Penalties for breach of listing rules.

91. - (1) If the competent authority considers that-

(a) an issuer of listed securities, or

(b) an applicant for listing,

has contravened any provision of listing rules, it may impose on him a penalty of such amount as it considers appropriate.

(2) If, in such a case, the competent authority considers that a person who was at the material time a director of the issuer or applicant was knowingly concerned in the contravention, it may impose on him a penalty of such amount as it considers appropriate.

(3) If the competent authority is entitled to impose a penalty on a person under this section in respect of a particular matter it may, instead of imposing a penalty on him in respect of that matter, publish a statement censuring him.

(4) Nothing in this section prevents the competent authority from taking any other steps which it has power to take under this Part.

(5) A penalty under this section is payable to the competent authority.

(6) The competent authority may not take action against a person under this section after the end of the period of two years beginning with the first day on which it knew of the contravention unless proceedings against that person, in respect of the contravention, were begun before the end of that period.

(7) For the purposes of subsection (6)-

(a) the competent authority is to be treated as knowing of a contravention if it has information from which the contravention can reasonably be inferred; and

(b) proceedings against a person in respect of a contravention are to be treated as begun when a warning notice is given to him under section 92.

Procedure.

92. - (1) If the competent authority proposes to take action against a person under section 91, it must give him a warning

notice.

(2) A warning notice about a proposal to impose a penalty must state the amount of the proposed penalty.

(3) A warning notice about a proposal to publish a statement must set out the terms of the proposed statement.

(4) If the competent authority decides to take action against a person under section 91, it must give him a decision notice.

(5) A decision notice about the imposition of a penalty must state the amount of the penalty.

(6) A decision notice about the publication of a statement must set out the terms of the statement.

(7) If the competent authority decides to take action against a person under section 91, he may refer the matter to the Tribunal.

Statement of policy.

93. - (1) The competent authority must prepare and issue a statement ("its policy statement") of its policy with respect to-

(a) the imposition of penalties under section 91; and

(b) the amount of penalties under that section.

(2) The competent authority's policy in determining what the amount of a penalty should be must include having regard to-

(a) the seriousness of the contravention in question in relation to the nature of the requirement contravened;

(b) the extent to which that contravention was deliberate or reckless; and

(c) whether the person on whom the penalty is to be imposed is an individual.

(3) The competent authority may at any time alter or replace its policy statement.

(4) If its policy statement is altered or replaced, the competent authority must issue the altered or replacement statement.

(5) In exercising, or deciding whether to exercise, its power under section 91 in the case of any particular contravention, the competent authority must have regard to any policy statement

published under this section and in force at the time when the contravention in question occurred.

(6) The competent authority must publish a statement issued under this section in the way appearing to the competent authority to be best calculated to bring it to the attention of the public.

(7) The competent authority may charge a reasonable fee for providing a person with a copy of the statement.

(8) The competent authority must, without delay, give the Treasury a copy of any policy statement which it publishes under this section.

Statements of policy: procedure.

94. - (1) Before issuing a statement under section 93, the competent authority must publish a draft of the proposed statement in the way appearing to the competent authority to be best calculated to bring it to the attention of the public.

(2) The draft must be accompanied by notice that representations about the proposal may be made to the competent authority within a specified time.

(3) Before issuing the proposed statement, the competent authority must have regard to any representations made to it in accordance with subsection (2).

(4) If the competent authority issues the proposed statement it must publish an account, in general terms, of-

(a) the representations made to it in accordance with subsection (2); and

(b) its response to them.

(5) If the statement differs from the draft published under subsection (1) in a way which is, in the opinion of the competent authority, significant, the competent authority must (in addition to complying with subsection (4)) publish details of the difference.

(6) The competent authority may charge a reasonable fee for providing a person with a copy of a draft published under subsection (1).

(7) This section also applies to a proposal to alter or replace a statement.

13.3 Factors relevant to determining the appropriate level of financial penalty

13.3.1 G 01.12.01/001

(1) The *FSA* will consider all the relevant circumstances of a case when it determines the level of financial penalty (if any) that is appropriate and in proportion to the contravention in question.

(2) With the exception of contraventions involving the submission of returns no more than 28 *business days* late (see ■ ENF 13.5), the *FSA* does not propose to adopt a tariff of penalties for different kinds of contravention. This is because there will be very few other cases in which all the circumstances of the case are essentially the same, and the *FSA* considers that, in general, the use of a tariff for particular kinds of contravention would inhibit the flexible and proportionate policy which it intends to adopt in this area.

13.3.2 G 01.12.01/001

(1) Section 69 of the *Act* (Statement of policy) requires that the *FSA's* policy in determining the amount of a penalty in relation to *approved persons* must include having regard to:

(a) the seriousness of the misconduct in question in relation to the nature of the principle or requirement concerned;

(b) the extent to which that misconduct was deliberate or reckless;

(c) whether the person on whom the penalty is to be imposed is an individual.

(2) Section 210(2) of the *Act* (Statements of policy) contains similar requirements for the *FSA's* policy in determining the amount of a penalty in relation to contraventions by *firms*.

13.3.3 G 01.12.01/001

The factors which may be relevant when the *FSA* determines the amount of a financial penalty for a *firm* or *approved person* include the following.

(1) The seriousness of the misconduct or contravention.

In relation to the statutory requirement to have regard to the seriousness of the misconduct or contravention, the *FSA* recognises the need for a financial penalty to be proportionate to the nature and seriousness of the misconduct or contravention in question. The following may be relevant:

(a) in the case of an *approved person*, the *FSA* must have regard to the seriousness of the misconduct in relation to the nature of the *Statement of Principle* or requirement concerned. Similarly, in the case of a *firm*, the *FSA* must have regard to the seriousness of the contravention in relation to the nature of the requirement contravened.

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(b) the duration and frequency of the misconduct or contravention (including, in relation to a *firm*, when the contravention was identified by *persons* exercising *significant influence functions* at the *firm*);

(c) whether the misconduct or contravention revealed serious or systemic weaknesses of the management systems or *internal controls* relating to all or part of a *firm's* business;

(d) the impact of the misconduct or contravention on the orderliness of financial markets, including whether public confidence in those markets has been damaged;

(e) the loss or risk of loss caused to *consumers* or other market users. If a contravention has caused loss to another *firm*, that *firm* may be able to take its own action against the *firm* which has committed the contravention; however, the *FSA* generally expects *firms* to comply with regulatory requirements, regardless of the nature of the counterparty; for example, persistent departures from ■ MAR 3 (Inter-professional conduct) may have implications for the *FSA's* assessment of a *firm's* continued fitness and propriety.

(2) The extent to which the contravention or misconduct was deliberate or reckless.

In determining whether a contravention or misconduct was deliberate, the *FSA* may have regard to whether the *firm's* or *approved person's behaviour* was intentional, in that they intended or foresaw the consequences of their actions. The matters to which the *FSA* may have regard in determining whether a contravention was reckless include, but are not limited to, the following:

(a) whether the *firm* or *approved person* has failed to comply with the *firm's* procedures;

(b) whether the *firm* or *approved person* has taken decisions beyond its or his field of competence;

(c) whether the *firm* or *approved person* has given no apparent consideration to the consequences of the *behaviour* that constitutes the contravention.

If the *FSA* decides that *behaviour* was deliberate or reckless, it may be more likely to impose a higher penalty on a *firm* or *approved person* than would otherwise be the case.

(3) Whether the *person* on whom the penalty is to be imposed is an individual, and the size, financial resources and other circumstances of the *firm* or individual.

This will include having regard to whether the *person* is an individual, and to the size, financial resources and other circumstances of the *firm* or *approved person*. The *FSA* may take into account whether there is verifiable evidence of serious financial hardship or financial difficulties if the *firm* or *approved person* were to pay the level of penalty associated with the particular contravention or misconduct. The *FSA* regards these factors as matters to be taken into account in determining the level of a penalty, but not to the extent that there is a direct correlation between those factors and the level of penalty. The size and financial resources of a *firm* or *approved person* may be a relevant consideration, because the purpose of a penalty is not to render a *firm* or *approved person* insolvent or to threaten its solvency. Where this would be a material consideration, the *FSA* will consider, having regard to all other factors, whether a lower penalty would be appropriate; this is most likely to be relevant to smaller *firms* or *groups* of

firms or *approved persons* with lower financial resources; but if a *firm* or individual reduces its solvency with the purpose of reducing its ability to pay a financial penalty, for example by transferring assets to third parties, the *FSA* will take account of those assets when determining the amount of a penalty. The size of the *firm* may also be a relevant consideration for the following reasons:

(a) the degree of seriousness of a contravention may be linked to the size of the *firm*. For example, a systemic failure in a large *firm* could damage or threaten to damage a much larger number of *consumers* than would be the case with a small *firm*: contraventions in *firms* with a high volume of business over a protracted period may therefore be more serious than contraventions over similar periods in *firms* with a smaller volume of business; and

(b) the size of a *firm* and its resources may also be relevant in relation to mitigation, in particular what steps the *firm* took after the contravention had been identified; the *FSA* will take into account what it is reasonable to expect from the *firm* in relation to its size and resources, and factors such as what proportion of a *firm's* resources were used to resolve a problem.

(4) The amount of profits accrued or loss avoided.

The *FSA* may have regard to the amount of profits accrued or loss avoided as a result of the contravention or misconduct, for example:

(a) the *FSA* will propose a penalty which is consistent with the principle that a *firm* or *approved person* should not benefit from the contravention or misconduct; and

(b) the penalty should also act as an incentive to the *firm* or *approved person* (and others) to comply with regulatory standards.

(5) Conduct following the contravention.

The *FSA* may take into account the conduct of the *firm* or *approved person* in bringing (or failing to bring) quickly, effectively and completely the contravention or misconduct to the *FSA's* attention and:

(a) the degree of cooperation the *firm* or *approved person* showed during the investigation of the contravention or misconduct (where a *firm* or *approved person* has fully cooperated with the *FSA's* investigation, this will be a factor tending to reduce the level of financial penalty);

(b) any remedial steps taken since the contravention or misconduct was identified, including identifying whether *consumers* suffered loss, compensating them, taking disciplinary action against staff involved (if appropriate), and taking steps to ensure that similar problems cannot arise in the future.

(6) Disciplinary record and compliance history.

The previous disciplinary record and general compliance history of the *firm* or *approved person* may be taken into account. This will include whether the *FSA* (or any *previous regulator*) has taken any previous formal disciplinary action, resulting in adverse findings, against the *firm* or *approved person*, or whether the *FSA* has previously required the *firm* to take remedial action by means of a variation of *Part IV permission* (see ■ ENF 3), or has previously requested the

firm to take remedial action, and the extent to which that action has been taken. For example, the disciplinary record of a *firm* or *approved person* could lead to the *FSA* increasing the penalty, where the *firm* or *approved person* has committed similar contraventions or misconduct in the past. In assessing the relevance of a *firm's* or *approved person's* disciplinary record and compliance history, the age of a particular matter will be taken into account, although a long-standing matter may still be relevant. However, in undertaking this assessment, private warnings will not be taken into account.

(7) Previous action taken by the *FSA*.

The action that the *FSA* has taken previously in relation to similar *behaviour* by other *firms* or *approved persons* may be taken into account. The *FSA* will seek to ensure consistency when it determines the appropriate level of penalty. If it has taken disciplinary action previously in relation to a similar contravention or misconduct, this will clearly be a relevant factor. However, as stated at ■ ENF 13.3.1 G, with the exception of the specific circumstances described at ■ ENF 13.5, the *FSA* does not intend to adopt a tariff system, and there may be other relevant factors which could increase or decrease the seriousness of the contravention or misconduct.

(8) Action taken by other regulatory authorities.

This could include for example:

(a) action taken or to be taken against a *firm* or *approved person* by other regulatory authorities which may be relevant where it relates to the contravention or misconduct in question;

(b) action taken by any *previous regulator* regarding the general level of penalties.

13.3.4 G 01.12.01/001 The list of criteria in ■ ENF 13.3.3 G above is not exhaustive, and all the relevant circumstances of the case will be taken into consideration.

13.3.5 G 01.12.01/001 Part III, Schedule 1 to the *Act* (Penalties and fees) specifically provides that the *FSA* may not, in determining its policy with respect to the amount of penalties, take account of expenses which it incurs, or expects to incur, in discharging its functions.

13.3.6 G 01.02.03/001 A *firm* (or *approved person*) may ask the *FSA* to permit the *firm* (or *approved person*) to pay a financial penalty by instalments. However, the *FSA* will consider agreeing to payment of a financial penalty by instalments only where there is verifiable evidence of serious financial hardship or financial difficulties if the *firm* or *approved person* were required to pay the full payment in a single instalment. This reflects the fact that the purpose of a penalty is not to render a *firm* or *approved person* insolvent or to threaten solvency. The *FSA* will determine the appropriate level and number of instalments having regard to the overall circumstances of the case. However, the period within which the full payment of the penalty must be made will not generally exceed one year from the date of the *final notice*.

G.N. 1410

SECURITIES AND FUTURES ORDINANCE (Chapter 571)

Pursuant to section 199(1) of the Securities and Futures Ordinance, the Securities and Futures Commission published the SFC Disciplinary Fining Guidelines in the Schedule for information.

28 February 2003

Alan Linning
Executive Director, Enforcement
Securities and Futures Commission

Schedule

SFC Disciplinary Fining Guidelines

Securities and Futures Ordinance
Considerations relevant to the level of a disciplinary fine

These guidelines are made under section 199(1)(a) of the Securities and Futures Ordinance to indicate the manner in which the Securities and Futures Commission (SFC) will perform its function of imposing a fine on a regulated person under section 194(2) or 196(2). Section 199(1)(b) requires the SFC to have regard to these guidelines in performing its function of fining under section 194(2) or 196(2). Section 199(2) sets out some factors that the SFC should take into account in exercising its fining power among other factors that the SFC may consider. These factors are included in the considerations set out below.

Under section 194 or 196 of the Ordinance, the SFC may impose a fine either on its own or together with other disciplinary sanctions. The SFC regards a fine as a more severe sanction than a reprimand (and a public reprimand more severe than a private reprimand). The SFC will not impose a fine if the circumstances of a particular case only warrant a public reprimand. As a matter of policy, the SFC will publicise all fining decisions. This means that the SFC will never impose both a fine and a private reprimand.

When considering whether to impose a fine under section 194(2) or 196(2) and the size of any fine, the SFC will consider all the circumstances of the particular case, including the Specific Considerations described below.

A fine should deter non-compliance with regulatory requirements so as to protect the public.

Although sections 194(2)(ii) and 196(2)(ii) state that one alternative maximum level of fine that can be imposed is three times the profit made or secured, or loss avoided or reduced, the SFC will not automatically link the fine imposed in any particular case with the profit made or secured, or loss avoided or reduced.

The more serious the conduct, the greater the likelihood that the SFC will impose a fine and that the size of the fine will be larger.

In determining the seriousness of conduct, in general, the SFC views some considerations as more important than others. The General Considerations set out below describe conduct that would be generally viewed as more or less serious. In any particular case, the General Considerations should be read together with the Specific Considerations in determining whether or not the SFC will impose a fine and, if so, the amount of the fine.

General considerations

The SFC generally regards the following conduct as more serious:

- conduct that is intentional or reckless
- conduct that damages the integrity of the securities and futures market
- conduct that causes loss to, or imposes costs on, others
- conduct which provides a benefit to the firm or individual engaged in that conduct or any other person.

The SFC generally regards the following conduct as less serious and so generally deserving a lower fine:

- negligent conduct – however, the SFC will impose disciplinary sanctions including fines for negligent conduct in appropriate circumstances
- conduct which only results in a technical breach of a regulatory requirement or principle in that it:
  + causes little or no damage to market integrity and
  + causes little or no loss to, or imposes little or no costs on, others

- conduct which produces little or no benefit to the firm or individual engaged in that conduct and their related parties.

These are only general considerations. These considerations together with the other circumstances of each individual case including the Specific Considerations described below will be determinative.

Specific considerations

The SFC will consider all the circumstances of a case, including:

The nature and seriousness of the conduct

- the impact of the conduct on the integrity of the securities and futures market
- whether significant costs have been imposed on, or losses caused to others, especially clients, market users or the investing public generally
- whether the conduct was intentional, reckless or negligent, including whether prior advice was sought on the lawfulness or acceptability of the conduct either by a firm from its advisors or by an individual from his or her supervisors or relevant compliance staff of the firm or group that employs him or her
- the duration and frequency of the conduct
- whether the conduct is widespread in the relevant industry (and if so, for how long) or there are reasonable grounds for believing it to be so widespread
- whether the conduct was engaged in by the firm or individual alone or whether as part of a group and the role the firm or individual played in that group
- whether a breach of fiduciary duty was involved
- in the case of a firm, whether the conduct reveals serious or systematic weaknesses, or both, in respect of the management systems or internal controls in relation to all or part of that firm's business
- whether the SFC has issued any guidance in relation to the conduct in question

The amount of profits accrued or loss avoided

- a firm or individual and related parties should not benefit from the conduct

Other circumstances of the firm or individual

- a fine should not have the likely effect of putting a firm or individual in financial jeopardy. In considering this factor, the SFC will take into account the size and financial resources of the firm or individual. However, if a firm or individual takes deliberate steps to create the false appearance that a fine will place it, him or her in financial jeopardy, eg by transferring assets to third parties, this will be taken into account
- whether a firm or individual brings its, his or her conduct to the SFC's attention in a timely manner. In reviewing this, the SFC will consider whether the firm or individual informs the SFC of all the conduct of which it, he or she is aware or only part, and the manner in which the disclosure is made and the reasons for the disclosure
- the degree of cooperation with the SFC and other competent authorities
- any remedial steps taken since the conduct was identified, including any steps taken to identify whether clients or others have suffered loss and any steps taken to sufficiently compensate those clients or others, any disciplinary action taken by a firm against those involved and any steps taken to ensure that similar conduct does not occur in future
- the previous disciplinary record of the firm or individual, including an individual or firm's previous similar conduct particularly that for which it, he or she has been disciplined before or previous good conduct
- in relation to an individual, his or her experience in the industry and position within the firm that employed him or her

Other relevant factors, including

- what action the SFC has taken in previous similar cases – in general similar cases should be treated consistently
- any punishment imposed or regulatory action taken or likely to be taken by other competent authorities
- result or likely result of any civil action taken or likely to be taken by third parties – successful or likely successful civil claims may reduce the part of a fine, if any, that is intended to stop a person benefiting from their conduct.