Report on the Securities and Futures Commission's 2006 annual review of the Exchange's performance in its regulation of listing matters

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EXECUTIVE SUMMARY

This report summarises the key findings and recommendations of the Securities and Futures Commission's 2006 annual review regarding the performance of The Stock Exchange of Hong Kong Limited (the "Exchange") in its regulation of listing matters during 2005.

Purpose of our assessment

The purpose of our assessment is to review the Exchange's operational procedures and decision-making processes to assess whether they are adequate to enable the Exchange to meet its statutory obligation to ensure, as far as reasonably practicable, an orderly, informed and fair market under section 21 of the Securities and Futures Ordinance (the "SFO").

Key observations and recommendations

We are of the view that the operational procedures and decision-making processes reviewed were appropriate to enable the Exchange to discharge its statutory obligation under section 21 of the SFO during the period reviewed, which saw an appreciable increase in the number of transactions handled. We also note the implementation of the majority of the recommendations made in our 2005 report and market participants' positive perception of the performance of the Exchange. However, we have also identified certain areas where we recommend that the Exchange review its existing procedures to enhance its performance.

The nature of our report is that it focuses on suggested areas for improvement for the Exchange to consider rather than the more positive aspects. However, we do not consider that the suggested areas for improvement detract from our affirmative overall conclusion.

This report records our assessment of the Exchange's performance for the year 2005. Our assessment does not take into account any developments since the conclusion of our on-site review on 16 June 2006, though we have included in the report details provided by the Exchange of actions it has taken subsequently.

We are satisfied that the Exchange has substantially addressed the main recommendations in our 2005 report and is developing policies to implement our other recommendations to:

a) institute a comprehensive risk based programme for reviewing listed companies' periodic reports, including annual reports; and

b) improve the transparency of its work and practices, particularly when implementing new practices, and specifically with regard to its approach to pre-vetting announcements.

Our key recommendations are that the Exchange should:

a) review its practices in relation to connected transactions;

b) review its practices relating to pre-deal research issued by sponsors, underwriters and their associates; and

c) expedite action to implement the remaining unaddressed recommendations in our 2005 report.

This report is divided as follows:

- Section 1 explains the purpose of our assessment, the scope of the review and the review process;
- Section 2 sets out our observations and recommendations;

- Section 3 presents our observations on how the Exchange has addressed the recommendations set out in our 2005 report, and states our recommendations on the outstanding matters;
- Appendix 1 is a table summarising our key recommendations made in this report and the Exchange's responses to them; and
- Appendix 2 contains the Exchange's report on how it has addressed the recommendations set out in our 2005 report.

Section 1: Introduction

1. This is our report on our 2006 review of the Exchange's performance in its regulation of listing matters during 2005.

Purpose and focus of our review

2. We have a statutory duty under section 5(1)(b) of the SFO to supervise, monitor and regulate the activities carried on by the Exchange. We have also agreed with the Exchange that we should periodically review the Exchange's performance in its regulation of listing-related matters in the Memorandum of Understanding between the Exchange and ourselves dated 28 January 2003 ("Listing Matters MoU").

3. In March 2004, the Government published its Consultation Conclusions on Proposals to Enhance the Regulation of Listing. Amongst other matters, the Government recommended that we prepare annual reports on our review of the Exchange's performance of its listing functions and submit these reports to the Financial Secretary, who would cause them to be published. This is our second report following the Government's recommendation.

4. As a recognised exchange under the SFO, the Exchange has a statutory obligation to:

   a) ensure an orderly, informed and fair market, so far as reasonably practicable, and

   b) act in the interest of the public, having particular regard to the interest of the investing public[1].

   The Exchange is also required under section 21(6)(b) of the SFO to provide and maintain competent personnel for the conduct of its business. The Exchange has agreed in the Listing Matters MoU to maintain an adequate level of staff strength in the Listing Division with an adequate level of professionalism and experience to discharge the responsibilities of the Listing Division.

5. As with our previous review, we reviewed the Exchange's operational procedures and decision-making processes to assess whether they are adequate to enable the Exchange to meet its statutory obligation under section 21 of the SFO.

6. The Exchange's statutory obligation under the SFO is ongoing, and whether it has made necessary arrangements to comply with its obligation in the future cannot be judged merely by reference to its past compliance. Therefore we use the review process to assess whether the Exchange has taken adequate steps to meet its statutory obligation and identify issues that, in our view, should be addressed to ensure ongoing compliance.

Our approach

7. We have adopted a risk-based approach in our review of the Exchange's performance. In drawing up the scope of our 2006 review, we sought to focus on areas that may pose a regulatory risk. Our review process looked at the Exchange's policies and practices and the approach it adopted in sample cases. The objective of selecting the sample

[1] Section 21 of the SFO

cases for review was to understand how the Exchange's policies work in practice and to verify whether the Exchange's practices follow its policies.

Scope of our review

8. In 2006, we reviewed the quality of the Exchange's decision-making process in each of the operational departments in the Listing Division, and reviewed its operational procedures in some functional areas not covered in our 2005 review.

9. Our review covered the Exchange's operations in 2005. Although our review primarily focused on listing applications, transactions and disciplinary cases handled during 2005, we also reviewed certain transactions occurring before or after 2005 where appropriate in order to obtain a proper perspective on the matters handled.

10. The Listing Division has three operational departments; they are:
    a) the Initial Public Offers Department (the "IPO Department") whose primary responsibility is to process new listing applications;
    b) the Compliance and Monitoring Department (the "C&M Department") which is responsible for monitoring listed companies' compliance with the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited (the "Listing Rules")[2]; and
    c) the Listing Enforcement Department (the "Enforcement Department") which investigates suspected breaches of the Listing Rules and institutes disciplinary action before the Listing Committee for such breaches by companies and their directors.

11. In respect of the work of the C&M Department, we took a thematic approach given the wide range of types of transaction that the department handles. We reviewed the following areas:
    a) short-term and long-term suspensions;
    b) vetting of circulars relating to issue of convertibles with significant price adjustment mechanisms; and
    c) granting of waivers.

12. We also reviewed the Exchange's operational procedures in handling complaints.

How we conducted the assessment

What we considered

13. In conducting the assessment, we have considered:
    - the relevant internal Exchange materials, written policies, procedures and processes documented by the relevant operational departments in the Listing Division and any general practices that have not been documented;

[2] References in this report to the "Listing Rules" refer to the Main Board Listing Rules and the GEM Listing Rules. For simplicity, references to a particular "Rule", "Rules", "Chapter" or "Chapters" refer to the Main Board Listing Rules only. The GEM Listing Rules contain broadly equivalent rules. As such, our observations and comments in this report apply equally to GEM.

- 121 sample cases, including the relevant operational departments' internal reports and case files;
- information we receive from the Listing Division in the ordinary course of our dealings with the Division, including its monthly report to us, internal reports and case data;
- the Hong Kong Exchanges and Clearing Limited 2005 annual report, the Exchange's quarterly newsletter called the "Exchange", and the 2005 Listing Committee Report;
- the Exchange's published disciplinary procedures, listing decisions, rejection letters, guidance letters, and other related documents on the HKEx website;
- discussions with senior management of the relevant operational departments in the Listing Division;
- the ICAC's reports on its findings in respect of the Exchange's handling of initial listing applications and complaints against listed companies dated 6 October 2004 and 6 October 2005 respectively;
- comments made in interviews or discussions with the relevant case officers;
- our continuing interaction with the Exchange under the Listing Matters MoU; and
- a consultation exercise to gauge the market's perception of the Exchange's performance in its listing-related functions, as mentioned below.

Gauging market perception of the Exchange's performance

14. As part of the review process, we consulted a number of market participants, including sponsors, legal advisers, accountants, investors and listed companies, and Listing Committee members, on a private and confidential basis, to establish how they view the performance of the Exchange in its regulation of listing matters. We envisage conducting further similar exercises in future years in order to gauge changes in the market's perception of the Exchange's performance over a period of time.

15. A total of 52 Listing Committee members and market practitioners participated in this exercise. Approximately two thirds of them (63%) were of the view that the Exchange's performance improved in 2005 and the remainder were of the view that the Exchange's performance remained the same.

16. We would like to thank the respondents, especially those who took time to add specific comments in their responses.

The assessment process

17. Our assessment of the Exchange's performance and our views expressed in this report are a combination of our on-site work, our consultation with market participants and Listing Committee members and our continuing interaction with the Exchange under the Listing MoU, as set out in paragraph 13 above. We have not taken into account any developments since the conclusion of our on-site review on 16 June 2006, though we have included in the report details provided by the Exchange of actions it has taken subsequently.

18. We conducted our on-site review principally from 17 March – 16 June 2006. We held an "exit" interview with the heads of the IPO Department, C&M Department and Enforcement Department which the Head of the Listing Division also attended. We discussed our findings with them at the "exit" interviews.

19. We sought the Exchange's comments on both the factual matters set out in this report and our conclusions. The Exchange's responses to our recommendations are set out in Appendix 1.

Section 2: Observations and recommendations

Overall assessment and areas for attention

20. Having reviewed the Exchange's decision-making processes in each of the operational departments in the Listing Division and its operational procedures in certain areas, we are of the view that the operational procedures and decision-making processes reviewed were appropriate during the review period to enable the Exchange to discharge its statutory obligation under section 21 of the SFO to ensure, so far as reasonably practicable, an orderly, informed and fair market. We identified certain areas for further attention as listed in paragraphs 23 and 24 below.

21. During 2005, the number of transactions the Exchange handled increased appreciably. Whilst the number of listing applications handled fell from 189 to 162 (down 14%), the number of circulars and announcements increased by over 20%; circulars rose 25% from 1,919 to 2,409; and announcements rose 21% from 9,092 to 11,092. The number of investigation cases increased 15% from 201 to 232.

22. Approximately two thirds of the market participants and Listing Committee members who responded to our consultation exercise on the Exchange's performance were of the view that the Exchange's performance improved in 2005: 33 of them (63%) held this view, and the remaining 19 (37%) were of the view that the Exchange's performance remained the same.

23. It is important to note that, while our report generally focuses on suggested areas for improvement for the Exchange to consider rather than the more positive aspects that support our overall conclusion stated in paragraph 20 above, we do not consider the suggestions for improvement in this report detract from that conclusion. Rather, they identify areas for potential improvement which we will continue to discuss with the Exchange.

24. In this section, we discuss areas where in our view the Exchange's practices can be improved. These areas are:

    a) when a series of connected transactions should be aggregated;

    b) whether a company should seek shareholders' approval when entering into a continuing connected transaction that is expected to exceed the *de minimis* level;

    c) divergence from the Listing Rules - pre-deal research; and

    d) convertible notes with significant price adjustment mechanisms.

25. We also discuss the Exchange's obligation to "*maintain an adequate strength of staff in the Listing Division with an adequate level of professionalism and experience*".

When a series of connected transactions should be aggregated

26. Under the Listing Rules, a series of transactions between a listed company and a party or parties connected or otherwise associated with one another should be aggregated if they are related[3]. The aggregation rules are designed to prevent listed companies from

[3] Rule 14A.25

"splitting" an otherwise significant transaction into smaller transactions so that, when the size tests are applied to each smaller transaction, it does not reach the relevant thresholds for requiring disclosure or shareholder approval. The Listing Rules set out the set of factors the Exchange should take into account when determining whether the connected transactions should be aggregated[4]. Chapter 14 contains similar rules on aggregation of notifiable transactions.

27. Whether two or more transactions should be aggregated depends on the facts and circumstances of each transaction. The Listing Division does not usually aggregate a series of transactions between two companies if the transactions are not of a similar nature. The Listing Division explained that it would not usually aggregate transactions of a revenue nature with transactions of an expense nature, in order to avoid creating potentially anomalous classification test results. The Exchange explained that it would consider all relevant factors that may indicate "splitting" of a transaction into a series of transactions in an attempt to circumvent the connected transaction requirements, and that in appropriate circumstances it is possible to aggregate revenue and expenditure items and capital, financing and revenue items, but that in practice there are few circumstances that warrant this treatment.

28. Whilst the practice described above provides a useful starting point for deciding whether to aggregate transactions, we are concerned that the Exchange may apply this guidance too rigorously.

29. Rules 14A.01 and 14A.02 set out the philosophy behind the connected transactions rules:

> "Rule 14A.01 *The connected transactions rules are intended to ensure that the interests of shareholders as a whole are taken into account by a listed issuer when the listed issuer enters into connected transactions. The rules set out in this Chapter also provide certain safeguards against listed issuers' directors, chief executives or substantial shareholders (or their associates) taking advantage of their positions.*
>
> Rule 14A.02 *This is achieved through the general requirement for connected transactions to be disclosed and subject to independent shareholders' approval. Accordingly, where any connected transaction is proposed, the transaction must be announced publicly and a circular must be sent to shareholders giving information about the transaction. Prior approval of the shareholders in general meeting will be required before the transaction can proceed. A connected person with a material interest in the transaction will not be permitted to vote at the meeting on the resolution approving the transaction.*"

30. Rule 14A.03 recognises that certain categories of transaction are exempt from the disclosure and independent shareholders' approval requirements, while certain other transactions are exempt from such approval but not disclosure (because they fall within *de minimis* levels specified in the Listing Rules[5]).

31. During our review we noted a particular case where a listed company entered into a series of continuing connected transactions with its parent company. The Exchange

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[4] Rule 14A.26
[5] See also Rule 14A.16

accepted the company's submissions that these transactions were not of similar nature and therefore were only subject to the disclosure requirements under Chapter 14A. Each of these transactions involved a different aspect of the subsidiary's business in a specialised industry and involved a degree of integration of the subsidiary's business with that of its parent company. The transactions represented different facets of the company's core business and several of the transactions related to the same subject matter, i.e. sale and distribution of the company's services and products. All the transactions were entered into on the same day or around the same time. Through not being aggregated, these transactions fell within the *de minimis* levels specified in the Listing Rules, and were thus exempt under Rule 14A.34 from the shareholders' approval requirement.

32. This is the only case of its type covered in our review. The relevant case officers and the senior management in the C&M Department explained that, in their view, the transactions were not of sufficiently similar nature to warrant aggregation and that the Exchange did not usually aggregate agreements of a revenue nature with those of an expense nature. They explained that the decision not to aggregate the transactions was in accordance with the Exchange's usual practice as explained in the Listing Decision No. 27-3 and the Exchange's Consultation Paper on the 1998/1999 Review of Certain Chapters of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited dated May 1999[6].

33. We are of the view that the Exchange's decision not to aggregate these transactions is inconsistent with the general principle in Rule 14A.01. We therefore recommend that the Exchange review its practice in this area to ensure that, when considering whether a series of transactions are related (including whether they are sufficiently similar in nature or whether agreements of a revenue nature and an expense nature should be aggregated), it does not allow companies to split a large transaction into smaller transactions to avoid the requirements for disclosure or prior shareholders' approval by drawing artificial or unduly fine distinctions between them.

Seeking shareholders' approval before entering into a continuing connected transaction expected to exceed the *de minimis* level

34. The general principle for connected transactions set out in Rule 14A.02 is that "prior approval of the shareholders in general meeting will be required before the transactions can proceed". A company is required to obtain prior approval from its independent shareholders for any continuing connected transaction which does not qualify for any other exemption unless the aggregate annual value is within the *de minimis* exemption set out in Rule 14A.34 (see next paragraph).

35. Rule 14A.34 provides a *de minimis* exemption from the independent shareholders' approval requirements, as follows:

> "*A continuing connected transaction on normal commercial terms where:*
>
> *(1) each of the percentage ratios (other than the profits ratio) is on* ***an annual basis*** *less than 2.5%; or*

[6] See paragraph 8 of section 2.2 and paragraph 14 of section 2.3 of the Consultation Paper on the 1998/1999 Review of Certain Chapters of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited dated May 1999

(2) each of the percentage ratios (other than the profits ratio) is on an annual basis equal to or more than 2.5% ***and the annual consideration is less than HK$10,000,000***

is only subject to the reporting and announcement requirements set out in rules 14A.45 to 14A.47 and is exempt from the independent shareholders' approval requirements of this Chapter." (Emphasis added).

36. Where the total annual value of a continuing connected transaction is expected to exceed the exemption limits in Rule 14A.34(1) and (2), a listed company should not be eligible for those exemptions and should obtain independent shareholders' approval before the transaction proceeds. Not requiring prior independent shareholders' approval would allow the company to enter into a transaction and only seek such approval when the total value of the transactions is about to exceed the *de minimis* level.

37. In one of the cases reviewed, we noted that the company anticipated that, based on projected transactions, it would exceed the annual cap during the year. To avoid triggering the requirement to obtain prior shareholders' approval for these transactions, the company set the annual caps within the *de minimis* exemption in Rule 14A.34 and advised that it would adhere to the caps or otherwise discontinue the arrangements before the relevant caps were exceeded unless independent shareholders' approval was obtained for higher caps. The company fully expected that it would need to seek its shareholders' approval for the transactions within 12 months.

38. The Listing Division explained that the question of whether the annual cap of a continuing transaction would be exceeded is a question of fact. Where the value of a continuing transaction is approaching the annual cap or the thresholds for shareholder approval, the company would be required to seek shareholders' approval of a revised cap if it intended to continue with the transaction, or alternatively the company must terminate the transaction to comply with the Listing Rules.

39. The issue here is not so much whether a company needs shareholders' approval for these transactions, but **when** it needs to seek shareholders' approval: either (i) when it first enters into them, or (ii) when the total value is about to exceed the *de minimis* level. As a matter of principle, when a company intends to enter into a continuing connected transaction, it should set the annual cap for the transaction at the **reasonably expected** total value of the transaction for the relevant year and accordingly comply with the relevant disclosure and/or shareholders' approval requirements if the expected total value of the transaction exceeds the relevant *de minimis* level.

40. The Exchange does not require a listed company to obtain prior shareholders' approval for a continuing connected transaction if the annual cap is set within the *de minimis* exemption in Rule 14A.34. We recommend that the Exchange revise its practice in this area, as it allows a listed company to set an annual cap within the *de minimis* exemption in Rule 14A.34 despite having a clearly stated expectation that it will exceed the cap and need to obtain its shareholders' approval within 12 months.

Divergence from the Listing Rules - pre-deal research

41. In 2004, the Exchange introduced a new Rule 8.21B which states that:

> "*Pre-deal research issued by the sponsor, each of the underwriters or their respective associates must not incorporate any profit forecast or other forward looking statements unless such statements are included, in substantially the same form, in the new applicant's listing document.*"

When Rule 8.21B was introduced, the Exchange explained that it codified the Exchange's practice of prohibiting the issue of pre-deal research with a profit forecast by sponsors, underwriters or their associates unless a profit forecast is included in the listing applicant's initial listing document. The Exchange also clarified that any forward-looking statements not included in an initial listing document should not be included in pre-deal research published by these parties[7].

42. Many sponsors expressed concerns when Rule 8.21B was introduced. Since then the Exchange has developed a practice such that sponsors, underwriters and their associates have been allowed to include in their pre-deal research a profit forecast or other forward looking statement in a form that is not substantially the same as the one included in the prospectus if:

a) there is a profit forecast in the prospectus; and

b) the sponsors and other relevant parties set up appropriate control measures to ensure:

   i) their analysts do not receive any material information regarding the new applicant that will not appear in the prospectus; and

   ii) the distribution of pre-deal research is restricted to professional investors; and

c) the control measures provide reasonable assurances that the pre-deal research is unlikely to affect the investment decisions of the general public.

43. During the course of our regular oversight of the Exchange during 2005, we had raised this issue with the Exchange. The Exchange explained that the purpose behind Rule 8.21B is to ensure that the prospectus contains all relevant information relating to the listing applicant: Rule 8.21B only required profit forecasts or forward looking statements provided by listing applicants to be included in prospectuses. As such, the Exchange stated that profit forecasts and forward looking statements prepared by sponsors, underwriters and their associates need not be included in prospectuses if the conditions in paragraph 42 are complied with.

44. This practice is significantly different from Rule 8.21B which explicitly states that the profit forecasts and other forward looking statements in pre-deal research materials must be in substantially the same form as those in the prospectus.

45. In commenting on the divergence between the Exchange practice and the Listing Rule, we make no comments on whether the Exchange practice or the Listing Rule is

[7] Paragraph 193 of the Consultation Conclusions on Proposed Amendments to the Listing Rules Relating to Initial Listing Criteria and Continuing Listing Obligations dated January 2004

the better policy[8]. We are merely noting that the Exchange's practice and policy on pre-deal research is at odds with the Listing Rules. It is not appropriate for the Exchange to develop a practice that is significantly different from the Listing Rules without going through due process to change the rules.

46. We recommend that the Exchange review its approach relating to pre-deal research issued by sponsors, underwriters and their associates, and consider whether a rule change or a general waiver is required.

Convertible notes with significant price adjustment mechanisms

47. Companies often issue convertible notes to raise funds. Convertible notes are debt securities that may be converted into shares of the issuer. Normally, the noteholder receives interest on the convertible notes and has an option to convert the notes into shares at a fixed conversion price.

48. In the last few years, several companies issued a particular type of convertible note, now commonly referred to as "toxic convertibles" because the notes have a floating conversion price which means that the number of shares into which the notes can be converted is uncertain. In the absence of other factors, each conversion is likely to lead to a reduction of the issuer's share price and an increase in the number of shares into which the remaining notes can be converted, resulting (because of the falling share price) in a spiral of further dilution of existing shareholders and reduction in share prices. In many cases the minimum conversion price is the par value of the issuer's shares. In the worst-case scenario, the notes are converted into shares at the par value and the convertible noteholders may end up holding almost all of the company's shares.

49. These convertibles created a significant over-hang on the market for the relevant shares. However, the announcements and circulars did not highlight the potential impact of issuing these convertible notes.

Disclosure

50. The Exchange vetted the accompanying announcements and circulars in accordance with its normal practice. In the cases we reviewed, the announcements and circulars did not highlight the impact of the transaction on the company's shareholders. The Exchange's comments on the draft announcements and circulars focused on technical compliance with the disclosure requirements in the Listing Rules. The terms and conditions of the convertible notes were fully disclosed in the circulars. However, the circulars did not sufficiently highlight the novel features that distinguish these convertible notes from conventional convertible notes that the market was familiar with, nor the potential impact of such transactions on the relevant company's shareholders.

[8] The issue of pre-deal research is one of the topics of a public consultation by the SFC, the results of which were recently published in the "Consultation Conclusions on the Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance" dated September 2006. The consultation conclusions paper indicated an approach to pre-deal research based on regulating analysts and the information they receive. However, the implementation of the revised proposals on pre-deal research in the consultation conclusions paper will require further public consultation and will not be completed in the immediate future.

51. During 2005, a number of market commentators remarked on the unusual nature of these convertibles. In light of these comments, the Exchange analysed a number of companies to determine the position and introduced new practices. The Exchange now requires substantially more disclosure in the circulars to inform shareholders of the potential dilutive effect of the notes and regular disclosure to keep investors informed. Companies issuing convertible notes of this type are required to make:

    a) monthly announcements on whether there was any conversion of the notes during the relevant month and the relevant details thereof; and

    b) an announcement whenever the cumulative amount of conversion shares issued reaches 5% of the companies' issued share capital.

52. Whilst the Exchange has addressed the concerns relating to these convertibles, we recommend that, in addition to checking compliance with the Listing Rules when reviewing announcements and circulars, the Exchange also focus on any novel features that could give rise to investor protection concerns. Such features should be brought to the shareholders' attention so that they can make a properly informed assessment of the transaction.

General mandate

53. Some of these convertibles notes were issued under a general mandate. A company cannot issue shares for cash under its general mandate if the price of the shares represents a discount of more than 20% to the benchmarked price under Rule 13.36(5)[9] unless the company is in a serious financial position and urgently requires rescue. When these convertible notes are converted into shares, which may occur at a substantial discount to the market price of the shares, the conversion does not fall within Rule 13.36(5).

54. Since the intention behind Rule 13.36(5) is to prevent issues of shares at a substantial discount without shareholders' approval, we recommend that the Exchange revisits the rules in this area and considers whether the limit on the amount of discount in Rule 13.36(5) should also apply to issues of securities for consideration other than cash.

Adequacy of staff levels in the C&M Department

55. Under the Listing Matters MoU the Exchange is required to "*maintain an adequate strength of staff in the Listing Division with an adequate level of staff professionalism and experience to discharge the responsibilities of the Listing Division*".

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[9] The benchmarked price under Rule 13.36(5) is the higher of:

(a) the closing price on the date of the relevant placing agreement or other agreement involving the proposed issue of securities under the general mandate; and

(b) the average closing price in the 5 trading days immediately prior to the earlier of:

  (i) the date of the announcement of the placing or the proposed transaction or arrangement involving the proposed issue of securities under the general mandate;

  (ii) the date of the placing agreement or other agreement involving the proposed issue of securities under the general mandate; and

  (iii) the date on which the placing or subscription price is fixed.

56. The Listing Division's budgeted headcount for professional staff was increased by 19% from 100 in 2004 to 119 in 2005[10]. However, the average actual headcount in the Listing Division increased by 10% in 2005, from 92 in 2004 to 102 in 2005, remaining below the budgeted headcount in both years. Despite the increase in professional staff within the Listing Division, our review indicates that the staff resources within the C&M Department are stretched to a greater extent than those of the other departments.

57. The C&M Department also suffered the highest turnover amongst the three operational departments within the Listing Division. The turnover among staff of senior manager grade or above increased almost fourfold from 8% in 2004 to 29% in 2005. The turnover in the C&M Department of 34% in 2004 and 28.6% in 2005 was two to three times greater than in the other departments.

58. The C&M Department routinely handles matters with a short life that typically must be handled within the day. The C&M Department's executive staff have to spend most of each working day dealing with urgent matters that arise during the day, such as:

- enquiries to listed companies regarding articles in the press containing potentially price sensitive information relating to the company;
- clearing draft announcements;
- enquiries to listed companies following unusual price or volume movements in these companies' shares.

These matters are urgent because they could potentially lead to a company being suspended if they are not dealt with expeditiously. In addition, staff are required to deal with other interruptions such as enquiries from listed companies and their advisers.

59. In the light of the broad range of the C&M Department's work, the short life span of its cases and staff resource issues, there is tremendous pressure on the staff to deal with the urgent matters first. As a result, there is a natural pressure for the C&M Department to take a reactive approach and prioritize urgent matters over important long-term work. Important but less urgent matters, such as clearance of circulars, review of financial statements, monitoring of long-suspended companies, and enquiries to companies regarding complaints, are usually dealt with after the relevant staff have dealt with all the urgent matters, or when the relevant company writes to the Exchange.

60. The senior management in the C&M Department has recognised the need to allow staff to manage their time more effectively and pro-actively so as to focus on important matters, and has started to review the department's work processes with a view to improving its distribution of work. We understand that the senior management is considering assigning the less urgent work to designated staff.

[10] The budgeted headcount in 2005 included two adjudicators that had been proposed as part of proposals to restructure the Listing Committee which did not proceed.

61. In mid 2006, the IPO Department seconded a few members of its staff to the C&M Department to deal with certain ad hoc projects that have longer lifespan so that these projects can be managed more proactively and effectively.

62. The Exchange has advised us that in mid 2006 the C&M Department set up a new team to handle projects and administrative matters, including publication of listing decisions. The project team takes on longer-term cases, policy matters and process improvement work, including streamlining of administrative routines and the consequential revision to procedural materials. It is taking steps to separate routine tasks performed by the C&M staff and to reassign these tasks to dedicated administrative personnel.

Recommendation

63. We recognize that the Exchange has identified the need to review the structure of and workflows within the C&M Department, and urge the Exchange to complete this process, as a matter of priority, including an assessment of the overall adequacy of resources.

Section 3: Implementation of recommendations in our 2005 report

64. As part of this year's review, we have also reviewed the Exchange's progress report on how it has addressed the recommendations in our 2005 report (see Appendix 2).

65. We are satisfied that the Exchange has substantially addressed the main recommendations in our 2005 report except for our recommendations to the C&M Department to:

    a) institute a financial statement review programme; and

    b) improve the transparency of its approach to pre-vetting announcements.

Financial statement review programme

66. In our last report, we noted that the Exchange did not have a formal protocol for reviewing listed companies' periodic financial statements. We recommended that the Exchange set up a comprehensive risk based programme to review these reports, including annual reports, to enhance the monitoring of listed companies' compliance with the Listing Rules. The Exchange has not yet set up its financial statement review programme and is still reviewing its approach and working to set up a framework and methodology for reviewing these reports.

67. There appears to be a lack of clarity within the C&M Department as to whether the rank and file staff are to continue with the current approach of reviewing the financial statements of newly listed companies and qualified financial statements. A few staff are under the impression that they no longer have to do so on the basis that this task has been assigned to other staff members of the Listing Division.

68. We strongly recommend that the Exchange finalise and set up its financial statements review programme and clarify with staff their responsibilities for this review work as a matter of priority.

Transparency

69. One of our main recommendations in our 2005 report was for the Exchange to improve the transparency of its decision-making processes and decisions and we commend the Exchange's efforts to improve in this area. However, we believe that there is still room for further improvement. Some of the market participants who participated in our consultation exercise on the Exchange's performance commented that although the Exchange has made considerable efforts towards improving transparency, it can further enhance the transparency of its decision-making processes. They suggested that the Exchange consider publishing its policy intention or rationale for new or revised policies and procedures so the market may better understand them.

The IPO Department

70. The IPO Department has worked to improve the transparency of its decisions by publishing more Listing Decisions, and copies of letters where it has rejected a listing application or given guidance on particular issues relating to initial public offerings.

71. The IPO Department advised that it had issued 63 guidance letters in 2005. However we note that it had only posted four guidance letters on the Exchange website. The

department explained that sponsors and listing applicants objected to the publication of the guidance letters they received because of confidentiality issues despite the fact that the Exchange has sought to remove all references to the listing applicant and related details that may identify the listing applicant.

72. We recommend that the IPO Department find ways to convey to the market as a whole the messages included in guidance letters which the relevant sponsors and listing applicants do not wish to be published.

The C&M Department

73. We have not noted any discernible improvement regarding the transparency of the C&M Department's work but we have been advised that the department intends to publish more Listing Decisions, particularly those that involve novel issues.

74. In our 2005 report, we recommended that the Exchange consider ways in which it can improve the transparency of its pre-vetting approach.

75. Although the Exchange started a pilot project to cease pre-vetting certain announcements in 2004, the Exchange continues to review draft announcements and give "guidance" on drafts submitted when requested to do so.

76. There has been some confusion in the market as to the Exchange's policy on which announcements are pre-vetted and which are post-vetted. A few of the market participants who participated in our consultation exercise on the Exchange's performance commented that the Exchange has not clearly defined the scope of pre-vetting. They suggested that the Exchange should publish clear directions on the types of announcement that are not required to be pre-vetted.

77. We note that following the completion of our on-site review the Exchange published a Guide on pre-vetting requirements for announcements on 11 August 2005.

The Enforcement Department

78. The Enforcement Department has posted its enforcement strategies and listed all public sanctions imposed since 2001 in a discrete section of the Exchange website. However, it does not include the terms of its settlement agreements with parties when it publishes public sanctions against them.

79. From the sample cases reviewed, we note that it is increasingly common for the Exchange to require relevant directors to undergo a certain number of hours of directors' training within a specified period when settling disciplinary actions. However, this requirement is not included in any announcement relating to a disciplinary action or public sanction. We believe such requirements should be included in the announcements of public sanctions where pertinent, as it sends a strong message to the market that directors who are not familiar with the Listing Rules may be required to undergo further training under certain circumstances.

80. It is important that the Exchange is seen as an effective enforcer of the Listing Rules. Whilst it may be necessary for the Exchange to keep confidential details of the settlement terms in individual cases, it is also important to keep the market apprised of the outcome of disciplinary actions taken, including the terms of any settlement agreements with listed companies and their directors.

81. We recommend that the Exchange communicate to the market:

a) its policy on settling disciplinary cases, and in particular the circumstances where settlement of disciplinary cases will require directors to undergo a certain number of hours of directors' training within a specified period; and

b) periodically, where for confidentiality reasons it is unable to disclose the terms of a settlement agreement with a particular listed company and its directors, the outcome of disciplinary actions taken on a no-name or an aggregate basis.

Appendix 1 – Exchange's responses to recommendations in the 2006 report

Paragraph references	Key recommendations	Exchange's response
When a series of connected transactions should be aggregated (paragraphs 26 – 33)	We recommend that the Exchange review its practice in this area to ensure that, when considering whether a series of transactions are related (including whether they are sufficiently similar in nature or whether agreements of a revenue nature and an expense nature should be aggregated), it does not allow companies to split a large transaction into smaller transactions to avoid the requirements for disclosure or prior shareholders' approval by drawing artificial or unduly fine distinctions between them.	The observations in paragraphs 26 to 40 relate to the same single case. The decisions made in that case were made in a manner entirely consistent with our internal decision making procedures. In the case in question views differ about what constitutes "transactions of similar nature" and whether the Listing Division took too narrow a view on this question. When making decisions that require the exercise of judgment it is possible for reasonable people, placing different weight on elements of the submissions received, to reach a different conclusion on those submissions. The Listing Division acknowledge the alternative views of this subject and we have shared and discussed these internally with a view to informing the exercise of judgment by staff in future cases exhibiting similar characteristics and concerns.

Paragraph references	Key recommendations	Exchange's response
Whether a company should seek shareholders' approval when entering into a continuing connected transaction it expects to exceed the *de minimis* level (paragraphs 34 – 40)	We recommend the Exchange revise its practice in this area, as it allows a listed company to set an annual cap within the *de minimis* exemption in Rule 14A.34 despite having a clearly stated expectation that it will exceed the cap and need to obtain its shareholders' approval within 12 months.	See above. The Division will continue to monitor future cases exhibiting similar characteristics and concerns.
Pre-deal research (paragraphs 41 – 46)	We recommend that the Exchange review its approach relating to pre-deal research issued by sponsors, underwriters and their associates, and consider whether a rule change or a general waiver is required.	The purpose of Rule 8.21B is to prevent issuer's circumventing the prospectus disclosure requirements to convey their profit forecasts and other forward looking statements through the medium of pre-deal research circulated by connected intermediaries. The Exchange's approach to administering Rule 8.21B is consistent with the policy decisions made by the Listing Committee when it adopted the rule and determined that: - The pre-existing practice of the Exchange relating to issuing pre-deal research and the inclusion of profit forecasts should be codified. - There should be no ban of pre-deal research. - If research was published in individual cases, compliance with Rule 8.21B could be considered on a case by case basis. The Listing Division has established a practice of reporting to the Listing Committee any guidance that is provided to sponsors regarding Rule 8.21B in individual cases to

Paragraph references	Key recommendations	Exchange's response
		ensure that compliance can be considered on a case by case basis. As part of this practice, the Listing Division requests and regularly receives assurance from sponsors that they believe their practices comply with Rule 8.21B. These assurances are critically reviewed, but are routinely accepted by the Listing Division and the Listing Committee prior to listing approval being granted. No waiver of Rule 8.21B has ever been granted. We note that the SFC recently published its Consultation Conclusions on Possible Reforms to the Prospectus Regime and determined not to regulate pre-deal research reports directly. In light of these conclusions and our experience with Rule 8.21B since its adoption the Listing Division believes it may be appropriate to revisit the Rule and interpretative practice in consultation with the Listing Committee in 2007. Such consulation would also take into account progress with the initiative to require earlier publication of prospectus information by listing applicants on the HKEx website after Listing Committee approval.
Convertible notes (paragraphs 47 – 54)	We recommend that the Exchange should: (a) in addition to checking compliance with the Listing Rules when reviewing announcements and circulars, also focus on any novel features that could give rise to investor protection concerns. Such features should be brought toshareholders' attention so that they can make a properly	(a) The Listing Division's comment letters are intended only to clarify and apply the Listing Rules, rather than to create new rights or duties unless the Listing Division invokes the Exchange's powers under Listing Rule 2.04 or its GEM Listing Rule equivalent (GLR2.07) to modify the application of the rules. Accordingly the Exchange's vetting process seeks to ensure that an announcement or document, as a whole, purports to comply with the Listing Rules. We think that it is entirely appropriate for the Listing Division to consider, in any individual case whether, in addition to the requirements of Listing Rule 2.13 or its GEM Listing Rule equivalent, it is appropriate for the Exchange to require (under LR 2.04 or GLR2.07) certain information to be disclosed with greater prominence. This approach recognises the need to react to a specific

Paragraph references	Key recommendations	Exchange's response
	informed assessment of the transaction; and	circumstance with a responsive and variable regulatory stance. At the same time it is important to acknowledge the need for consistency in regulation and whilst the vetting process for announcements and circulars can be used to modify disclosure practices there is also a danger that to require additional disclosure beyond the disclosure requirements set out in the Listing Rules on an ad hoc basis would become arbitrary and add uncertainty in the application of those rules. The Exchange may be seen to assume responsibility for the manner in which information is presented in individual cases and there is a greater risk that the personal preferences of individual Exchange staff are substituted for the requirements of the Listing Rules. It is for these reasons, amongst others, that the Exchange is looking to reduce rather than increase the extent of its pre-vetting activities. Going forward the underlying concerns of the SFC will need to be addressed by listed issuers, in the first instance, and then through regulatory policy initiatives, guidance and enforcement action rather than through pre-vetting activities. During the transition to this model the Listing Division will continue to consider the need to vary the application of the Listing Rules on an individual basis during the vetting process.
	(b) revisit the rules in this area and consider whether the limit on the amount of discount in Rule 13.36(5) should also apply to issues of securities for consideration other than cash.	(b) The Listing Division will seek the views of the Listing Committee on the necessity and scope of a new requirement to limit the discount of non-cash share issues at an appropriate opportunity during 2007.

Paragraph references	Key recommendations	Exchange's response
Adequacy of staff in the C&M Department (paragraphs 55 – 63)	We recommend that the Exchange to complete its review of the structure of and workflows within the C&M Department, as a matter of priority, including an assessment of the overall adequacy of resources.	The Exchange will continue to review the adequacy of staff resources devoted to the listing function, including the C&M Department, on a periodic basis. The Listing Division will also continue with its review of C&M practices and procedures and an associated comprehensive review of information technology applications during 2007 and 2008.
Financial statement programme review (paragraphs 66 – 68)	We strongly recommend that the Exchange finalise and set up its financial statements review programme and clarify with staff their responsibilities for this review work as a matter of priority.	During the year to date the Listing Division has continued to review financial statements under its existing methodology. Preparation of a framework and methodology for a revised approach to the review of periodic financial information is well advanced. During 2006 the Division reached agreement with HKICPA concerning the sharing of intelligence and the detailed results of the work of the Professional Standards Monitoring Committee. A paper on the Listing Division's proposed methodology will be presented at a Listing Committee meeting in early 2007. The proposal will take into account the revised arrangements with HKICPA and the impact of the establishment of the Financial Reporting Council (FRC) on the Listing Division's work and its future role in identifying reasonable suspicion of non-compliance with accounting, auditing and professional standards and making appropriate referrals to either the FRC or HKICPA for their further assessment. The proposal will also take into account the views of the Listing Committee expressed at its November 2006 Policy meeting.

Paragraph references	Key recommendations	Exchange's response
Improving transparency in respect of the IPO Department (paragraphs 69 – 72)	We recommend that the IPO Department find ways to convey to the market as a whole the messages included in guidance letters which the respective sponsors and listing applicants do not wish to be published.	The IPO Department will consider how best to take forward the SFC's recommendation.

Paragraph references	Key recommendations	Exchange's response
Improving transparency in respect of the Enforcement Department (paragraphs 73 – 81)	We recommend that the Exchange communicate to the market: • its policy on settling disciplinary cases, and in particular the circumstances where settlement of disciplinary cases will require directors to undergo a certain number of hours of directors' training within a specified period; and • periodically, where for confidentiality reasons it is unable to disclose the terms of a settlement agreement with a particular listed company and its directors, the outcome of disciplinary actions taken on a no-name or an aggregate basis.	The Enforcement Department will prepare a paper recommending to the Listing Committee that a clearly articulated statement of settlement policy, including the publicity implications thereof, be published on the web-site for consideration at the policy meeting in the first quarter of 2007.

Appendix 2 – Action taken by the Exchange in response to the recommendations in the 2005 report

Findings (Extracts)	Recommendations	Actions Taken in response to the SFC's 2005 report on the Exchange's performance
(a) Internal guidelines issued by IPO on policies and practices are not available to the public	IPO should consider how it could communicate its practices and policies to the market generally. It should review its internal guidance for staff to see which of these could be communicated to the market.	The IPO Department has taken steps to institutionalise formal procedures to publish listing decision and rejection letters on a regular basis to enhance the transparency of IPO practices and policies in listing-related matters. As part of this effort, it has published the following documents in 2005: 1. "Guidelines for New Listing Applications" www.hkex.com.hk/issuerservice.htm; 2. 24 Listing Decisions; 3. 6 Rejection Letters The IPO Department has taken steps to ensure that it has dedicated staff and formal procedures in place to continue to update and publish such information on a regular basis going forward.
(b) Changing, without prior warning, practices or approach in a way that might have a significant impact on the market and may disrupt the listing application process	Where IPO changes an established practice or approach in a way that would be expected to have a significant impact on the market but which does not involve a rule change or modification that requires the SFC's prior consent, IPO should consider providing prior notice to the market before implementing the changes.	The IPO Department has reviewed its internal guidance to staff and prepared written administrative procedures for its key areas with a view to sharing the information amongst the Exchange staff and, where appropriate the market to ensure that comments by staff members on individual cases do not have a significant market impact.

Findings (Extracts)	Recommendations	Actions Taken in response to the SFC's 2005 report on the Exchange's performance
(c) IPO does not have an electronic database to capture all of its precedent and knowhow materials.	IPO should consider establishing an electronic database comprising all its precedent and knowhow materials.	The IPO Department launched its IPO Case Database in August 2005. The IPO Case Database is equipped with the functionality to capture the Division's precedent and know-how materials through the provision of information on waivers applied and granted or rejected in relation to a listing applicant. Continued enhancement of the Case Database shall be undertaken as one of the key policy initiatives of the Listing Division for 2006 to conduct a comprehensive review of information technology needs and practices.
(d) No formal protocol for reviewing periodic reports.	To institute a comprehensive risk based programme for reviewing listed companies' periodic reports, including annual reports.	Preparation of a framework and methodology for a revised approach to the review of periodic financial information is underway. During 2006 the Listing Division reached an agreement with the Hong Kong Institute of Certified Public Accountants ("HKICPA") concerning the sharing of intelligence and the detailed results of the work of the Professional Standards Monitoring Committee. A paper on the Listing Division's proposed methodology will be presented at the Listing Committee Policy meeting in early 2007. The proposal will take into account the revised arrangements with the HKICPA and the impact of the establishment of the Financial Reporting Council ("FRC") on the Listing Division's work and its future role in identifying reasonable suspicion of non-compliance with accounting, auditing and professional standards and making appropriate referrals to the FRC for its assessment. The proposal will also take into account the views the Listing Committee expressed at its November 2006 Policy meeting.

Findings (Extracts)	Recommendations	Actions Taken in response to the SFC's 2005 report on the Exchange's performance
(e) C&M does not have a comprehensive or detailed case management system that allows the Head of the Department to monitor the various teams' performance, and the timeliness of their work.	To establish a comprehensive and detailed case management systems that covers all the work of the Department, so as to enable senior management to analyse the Department's work and assess its performance with a view to improving the Department's efficiency and effectiveness.	The Listing Division commenced a feasibility study on how to develop the management reporting capability of its database and add workflow related functionality and other features to the overall IT systems for the Listing Division. The Listing Division has developed the following tools to assist management in monitoring the C&M Department's performance: 1. Case Database, which went live in August 2005 and which contains, amongst others, information on price and volume alerts and complaints; 2. Case Control Log, which enables the Head of the C&M Department to monitor the status and ageing of transactions. Since January 2006, Exception Reports have been generated on a weekly basis out of the Case Control Log. The reports set out the list of transactions whose processing time exceeds those of the internally-set benchmarks and the reasons for the exceptions. 3. The C&M Department has, since March 2005, generated reports on suspended companies on a weekly basis. The reports enable the Head of the Listing Department to appraise of the status and actions taken towards suspended companies. Alongside with the Exception Reports, other pertinent operational statistics covering the regulatory activities of the C&M Department, the turnaround time of such activities and the number of transactions by category are also generated out of the C&M Log Book, which provide information to Senior Management on the performance of the department.

Findings (Extracts)	Recommendations	Actions Taken in response to the SFC's 2005 report on the Exchange's performance
(f) The Exchange has not announced the pilot project to reduce the extent of its pre-vetting activities.	To improve the transparency of its work and practices, particularly when it is implementing new practices.	The Listing Committee considered a policy paper in January 2006 outlining the Exchange's plan to implement a reduction in pre-vetting of announcements and circulars. As part of that plan, the Listing Division commenced a soft consultation with market practitioners and listed companies in July 2006 and published the Guide on pre-vetting requirements for announcements on 11 August 2006. A further policy paper incorporating proposals for amendments to the Listing Rules will be considered at a future Listing Policy Meeting.
(g) Ensuring consistency of approach and decisions represents a significant challenge for C&M. C&M should consider how to bring together all the experience and knowledge held within the Department in a way that is readily accessible to all staff.	To establish an electronic database capturing all its precedent and knowhow materials.	The C&M Department retained its existing systems for capturing precedent materials and know-how and renewed contracts with independent third party information providers to provide additional resources for the Exchange staff. It has reviewed and enhanced its file indexing protocols with a view to increasing the efficiency of retrieval of information via the ISYS system. Implementation of the enhancements, including installation of specific features at individual PCs of the C&M Department staff members, was completed in May 2006. The Listing Division as a whole is undertaking a comprehensive review of information technology needs and practices and expect changes to be made to improve the functionality of their electronic records as a result of this larger project.

Findings (Extracts)	Recommendations	Actions Taken in response to the SFC's 2005 report on the Exchange's performance
(h) LED does not make available under a discrete section on the HKEx website information relating to the Department's enforcement strategy and disciplinary actions taken.	LED should consider archiving information regarding its enforcement philosophy and policy and disciplinary actions in one dedicated section on the HKEx website to promote ease of search and access to the information. There should be a search facility to enable investors to find out whether a particular company or individual has been censured.	A new dedicated section on LED's enforcement strategy and disciplinary actions taken has been posted on the "Listing Matters and Listed Companies" section of the HKEx website since 1 July 2005. The section includes a copy of the article carried in the October 2004 edition of the Exchange magazine describing the Listing Division's enforcement strategy and a searchable database of disciplinary decisions.

Findings (Extracts)	Recommendations	Actions Taken in response to the SFC's 2005 report on the Exchange's performance
(i) There are inconsistencies in the retrieval of information from the HKEx website and the GEM website. There are also incidents of incompleteness of the search results of both websites where the companies changed their names during the search period.	The Exchange should review the presentation of information and completeness of the search function on both the HKEx and the GEM websites	The Exchange initiated a project focusing on enhancement of issuer news dissemination and improving the presentation of information on the HKEx and GEM websites. On 4 September, the Exchange introduced new features on its website to improve investors' access to the latest listed company documents, as well as related archives, strengtening the company information dissemination regime in Hong Kong. The new features include: • A more user-friendly presentation of the latest company documents. Users are able to retrieve the latest company documents for a particular securities type or by document type more easily; • Displays of company documents for past seven calendar days instead of just the current day; • Displays of the file size and format of each company document for users' reference; • A new search form for company documents to simplify the search process and make it more user friendly – this form has also been adopted on the GEM website; • A new "Listed Company Information Search – Delisted Securities" section to facilitate searches on delisted securities and lapsed initial public offerings. The Exchange believes the new features will further strengthen the website's role as a centralised resource centre for online access to information on Hong Kong listed companies.

Findings (Extracts)	Recommendations	Actions Taken in response to the SFC's 2005 report on the Exchange's performance
(j) Microsoft releases many security patches during a year and ranks as "critical" those patches which it deems crucial to address system vulnerabilities and recommends should be applied in a timely manner.	IT Division to consider amending its implementation practice to install at six monthly intervals all outstanding security patches relevant to the HKEx's computer systems that Microsoft identifies as "critical" and which have not already been installed.	The Exchange has updated the Microsoft Service Pack/ Security Patch Implementation Strategy to specify that all critical security patches relevant to EPS and ESS computer systems will be installed at six monthly intervals. The updated strategy was approved by the IT Architectural Working Group at its meeting held on 28 November 2005.The first implementation cycle for 2006 was completed on 25 March 2006.