

**Report on the Securities and Futures Commission's
2007 annual review of the Exchange's performance
in its regulation of listing matters**

2007

CONTENTS	PAGE
Executive summary	1
Purpose of our assessment.....	1
Key observations and recommendations	1
Section 1: Introduction	2
Purpose and focus of our review.....	2
Our approach.....	3
Scope of our review	3
How we conducted the assessment	3
What we considered.....	3
Gauging market perception of the Exchange’s performance.....	4
The assessment process	4
Section 2: Overall assessment	5
Overall assessment.....	5
Market perception of the Exchange’s performance	5
Observations on the Listing Division’s performance.....	5
Level of activities	5
The Listing Division.....	6
Recommendation.....	7
Appendix 1 - Action taken by the Exchange in response to the recommendations in the 2006 report...8	
Appendix 2 - Summary of the results of the survey of the Listing Committee members and market participants' view of the Exchange's performance.....	12

EXECUTIVE SUMMARY

This report summarises the key findings and recommendations of the Securities and Futures Commission's 2007 annual review regarding the performance of The Stock Exchange of Hong Kong Limited (the "Exchange") in its regulation of listing matters during 2006.

Purpose of our assessment

This report records our assessment of the Exchange's performance for the year 2006.

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

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.

We are satisfied that the Exchange has taken steps to address the recommendations in our 2006 report. Since the period covered in our 2005 annual review, the Exchange has strived to improve its performance by restructuring the Listing Division, reviewing its practices and procedures. This has led to improved efficiency and timeliness in the IPO Department and Enforcement Department. The C&M Department has also reviewed and streamlined its decision-making processes in 2006. We note and commend the enhancements in the Listing Division's operational procedures and decision-making processes which contribute to a more consistent regulatory approach by the Division. Overall, we find the Exchange's performance has improved in the past three years.

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, including our observations on how the Exchange has addressed the recommendations set out in our 2006 report;
- Appendix 1 contains the Exchange's report on how it has addressed the recommendations set out in our 2006 report; and
- Appendix 2 is a table summarising the results of a survey of the Listing Committee members and the market participants' view of the Exchange's performance.

Section 1: Introduction

1. This is our report on our 2007 review of the Exchange's performance in its regulation of listing matters during 2006.

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 third report following the Government's recommendation.
4. As a recognised exchange under the SFO, the Exchange has statutory obligations 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 public¹.

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. It has also 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. Except for matters specifically reserved by the Listing Committee, most matters concerning the Listing Rules are dealt with by the Listing Division in the first instance. Matters dealt with by the Listing Division include processing listing applications, monitoring and enforcing listed companies' compliance with the Listing Rules.
6. 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 obligations under section 21 of the SFO.
7. 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.

¹ Section 21 of the SFO

Our approach

8. Our review process looked at the Listing Division's operational procedures and decision-making processes as a whole. We reviewed sample cases in order to understand how the division's policies work in practice and to verify whether the division's practices follow its policies.

Scope of our review

9. We focussed on reviewing the decision-making process and operational procedures in each of the operational departments in the Listing Division during our annual review of the Exchange's performance in its regulation of listing matters.
10. We did not review the quality of the Listing Division's decisions during the annual review process as this forms part of our regular oversight function of the Exchange under section 5(1)(b) of the SFO. We will raise and discuss with the Exchange any particular matter which comes to our attention during the course of the year as and when such matter arises.
11. In 2007, we reviewed the Listing Division's operations in 2006. 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.

How we conducted the assessment

What we considered

12. 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;
 - 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;

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.

- the Hong Kong Exchanges and Clearing Limited 2006 annual report, the Exchange’s quarterly newsletter called the “Exchange”, and the 2006 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;
- comments made in interviews or discussions with the relevant case officers;
- our continuing interaction with the Exchange under the Listing Matters MoU; and
- a survey of market participants’ views 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

13. As part of the review process, we conducted a survey of a number of market participants, including sponsors, legal advisers, accountants, investors and listed companies, and Listing Committee members, on a private and confidential basis. The purpose of the survey is to establish how they view the Exchange’s performance in its regulation of listing matters and to gauge changes in the market’s perception of the Exchange’s performance over a period of time.

The assessment process

14. 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.
15. We held an “exit” interview with the heads of the IPO Department, C&M Department and Enforcement Department. We discussed our findings with them at the “exit” interviews.
16. We sought the Exchange’s comments on both the factual matters set out in this report and our conclusions.
17. The matters discussed in this report are as at June 2007.

Section 2: Overall assessment

Overall assessment

18. Having reviewed the Exchange's operational procedures and decision-making processes in each of the Listing Division's operational departments during 2006, we are of the view that they were appropriate during the review period to enable the Exchange to discharge its statutory obligation to ensure, so far as reasonably practicable, an orderly, informed and fair market.

Market perception of the Exchange's performance

19. We sent a questionnaire on the Exchange's performance to 104 Listing Committee members and market practitioners and received 46 responses.
20. The respondents were asked to rate the performance of the Exchange and each of the operating departments in the Listing Division in various key areas on a scale of 1 to 5 with "5" being wholly satisfied. Please refer to Appendix 2 for detailed summary of the result of the survey.
21. Overall, there is no significant change in the respondents' view of the Exchange's performance. The respondents were least satisfied with the timeliness of disciplinary action taken against listed companies and their directors and the transparency of the Exchange's policy on disciplinary actions.
22. There were also several calls by the respondents for the Exchange to improve the transparency of its decisions and timeliness of its disciplinary actions. These respondents believe that the market will benefit from greater transparency regarding the Exchange's decisions and decision-making process. A few of them noted that the Exchange has improved the transparency of its decisions but believed that the market would benefit from greater transparency.
23. In the past 2 years, the Exchange has sought to improve the transparency of its decisions, by publishing its Listing Decisions, guidelines, FAQs to some of its new initiatives, letters to listed companies, and staff interpretation on the HKEx website. The Exchange has also taken steps to improve the transparency of its approach in disciplinary actions. Please see paragraph 31 below.
24. We also note that the average time for the Enforcement Department to complete investigation cases improved in 2006. Please see paragraph 32 below.

Observations on the Listing Division's performance

Level of activities

25. During 2006, the C&M Department saw an 11% increase in the number of compliance and monitoring actions, as reported in the HKEx 2006 annual report, from 23,223 to 25,732. In particular, the number of cases the C&M Department referred to the Enforcement Department for further investigation increased significantly in 2006 from 88 to 141 cases (up 60%).

26. The number of listing applications and investigations handled by the IPO Department and the Enforcement Department fell: the number of listing applications accepted for vetting fell from 111 to 88 (down 21%) and the number of investigation cases fell 7% from 232 to 216.

The Listing Division

27. We note and commend the enhancements in the Listing Division's operational procedures and decision-making processes which contribute to a more consistent regulatory approach by the Division.
28. The revised procedures in the IPO Department and Enforcement Department, which have been implemented and refined since the end of 2004, appear to be well bedded within these departments. Their revised procedures and processes have improved the efficiency and timeliness of each of the department's work.
29. The head of the IPO Department and team leaders of the department are involved at the early stage of the vetting process to ensure that material issues are identified in the first comment letter.
30. Where a case involves novel issues, the IPO Department will consult the Listing Committee at an early stage. Further during 2006, the IPO Department introduced a number of measures to shorten the waiting period before the Listing Committee hearing, including internal "70-day" protocol to allow the relevant case officers to consult the Listing Committee on a listing application earlier in the vetting process. This has reduced the average waiting period before a listing application is tabled before the Listing Committee from 18 weeks in the 1st half of 2006 to 12 weeks in the second half of the same year. It has also enabled listing applicants and their advisers to address the Listing Committee's views and concerns at an earlier stage.
31. In response to our 2006 report, the Enforcement Department published the Exchange's settlement policy in respect of disciplinary actions against listed companies and their directors in June this year. The market can also find information on the sanctions imposed by the Listing Committee from 2001 on the HKEx website. Transparency of the department's approach in disciplinary actions has improved in the last 2 years.
32. The average time for the Enforcement Department to complete an investigation case has improved from 17 to 12 months in 2006. The department also completed more investigation cases within 2 years in 2006 compared with 2005: 119 investigation cases (82%) were completed within 2 years in 2006 compared with 108 cases (68%) in 2005.
33. In respect of our recommendation to improve the adequacy of staff in the C&M Department in our 2006 report, the budgeted headcount in the C&M Department was increased by almost 12% for 2006 and by a further 19% in 2007. The HKEx Board also reviewed the adequacy of staff levels in the C&M Department in April 2007.
34. During the course of 2006, the C&M Department reviewed and revised its decision-making processes and operational procedures to make more efficient and effective use of its regulatory resources. It has also introduced a case management database which allows senior management and case officers to monitor the progress of any transaction or matter at hand. We understand that further developments are planned.

35. Further, important work that is not time critical has been assigned to a dedicated team to ensure that such matter receive appropriate attention and is not pushed back by the need to work on time sensitive matters.
36. To ensure that material issues are identified and discussed by senior management, the head of the C&M Department and various team leaders of the department meet daily to discuss any novel or complex issues and all waiver applications except routine applications to extend deadlines for publication of documents under the Listing Rules. This also helps ensure consistency of decisions and actions by the various teams in the department.
37. Given that these revised processes and procedures were only recently introduced, it would be premature to assess their impact. However, from our discussion with various staff and senior management in the C&M Department, we believe that these newly implemented processes and procedures have made a positive difference and are contributing to a more focussed and efficient approach by the department.

Recommendation

38. We recommend that the Exchange continue to strive to improve the transparency and timeliness of its decisions and actions.
39. We recommend the C&M Department continues its efforts to review and streamline its operational processes and decision-making procedures.

Appendix 1 – Action taken by the Exchange in response to the recommendations in the 2006 Report

SFC 2006 Audit Recommendations Implementation Action Plan

Date: 22 June 2007

Paragraph References	Recommendations	Responsibility Assigned	Status	% of Completion	Progress on Implementation As at 22 June 2007
1. Pre-deal research (paragraphs 41-46)	The Exchange is recommended to 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.	IPO	In Progress	70%	A paper on this topic was presented to the Listing Committee at its policy meeting on 23 April 2007. The Division is in discussion with the SFC on the recommended actions.
2. Improving transparency in respect of the IPO Department (paragraphs 69-72)	IPO Department is recommended to 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.	IPO	In Progress	90%	The Division has reviewed past guidance letters and has prepared three draft letters which are being reviewed for publication in due course.
3. When a series of connected transactions should be aggregated (paragraphs 26-33)	The Exchange is recommended to 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.	C&M	Completed	100%	Please refer to our response in the 2006 report. The case reviewed by the SFC was a specific incident and not indicative of the handling of similar issues generally. The Listing Division notes the fundamental concern is the possible circumvention of the connected transaction requirements. The alternative view in this subject has been discussed with the team leaders of the C&M team. Where there are similar issues relating to aggregation, such issues are expected to be identified and discussed during the daily pre-clearance meetings, in the same manner as other cases where the structuring of transaction posts questions on whether the Listing Rules are being circumvented. In 9/2006 C&M formalized its practice on signing authorities and decision making forum (see bulletin 2006/ No.4) which contains requirement for sign off of announcements for connected transactions at the team leader level.

Appendix 1 – Action taken by the Exchange in response to the recommendations in the 2006 Report

SFC 2006 Audit Recommendations Implementation Action Plan

Date: 22 June 2007

Paragraph References	Recommendations	Responsibility Assigned	Status	% of Completion	Progress on Implementation As at 22 June 2007
4. Whether a company should seek shareholders' approval when entering into a continuing connected transaction it expects to exceed the <i>de minimis</i> level (paragraphs 34-40)	The Exchange is recommended to revise its practice in this area, as it allows a listed company to set an annual cap within the <i>de minimis</i> 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.	C&M	Completed	100%	See above.
5. Convertible notes (paragraphs 47-54)	The Exchange is recommended : (a) in addition to checking compliance with the Listing Rules when reviewing announcements and circulars, should also focus on any novel features that could give rise to investor protection concerns. Such features should be brought to shareholders' attention so that they can make a properly informed assessment of the transaction; and (b) to 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 to securities for consideration other than cash.	C&M	In Progress	70%	(a) Please refer to our response in the 2006 report. It is the issuers' responsibility to comply with the Listing Rules (including Rule 2.13). Prior to full post-vetting of announcements, the Division will continue to consider issuer's compliance with Listing Rules, including the materiality of disclosure, in carrying out its pre-vetting process. (b) The issue of general mandate is one of the topics to be included in the combined consultation paper to be issued in 2007.

Appendix 1 – Action taken by the Exchange in response to the recommendations in the 2006 Report

SFC 2006 Audit Recommendations Implementation Action Plan

Date: 22 June 2007

Paragraph References	Recommendations	Responsibility Assigned	Status	% of Completion	Progress on Implementation As at 22 June 2007
6. Adequacy of staff in the C&M Department (paragraphs 55-63)	The Exchange is recommended 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.	C&M	Ongoing	N/A	<p>The assessment of the adequacy of resources is carried out in conjunction with the review of C&M practices and procedures and streamlining of such procedure. It is expected that this process will be continuous.</p> <p>Following publication of the 2006 report, the HKEx Board requested a briefing on the subject.</p> <p>On adequacy of resources, the C&M team increased its actual professional headcount from 46 staff in December 2006 to 50 staff as at 22 June 2007. We are also recruiting for four positions at senior manager and manager.</p>
7. Financial Statement programme review (paragraphs 66-68)	The Exchange is strongly recommended to finalise and set up its financial statements review programme and clarify with staff their responsibilities for this review work as a matter of priority.	Accounting Affairs	Completed	100%	<p>The Programme has been pilot-tested and work will commence on 3 July 2007.</p> <p>SFC has commented on the general approach to the Programme, including the review coverage on large-cap and mid-cap companies.</p>

Appendix 1 – Action taken by the Exchange in response to the recommendations in the 2006 Report

SFC 2006 Audit Recommendations Implementation Action Plan

Date: 22 June 2007

Paragraph References	Recommendations	Responsibility Assigned	Status	% of Completion	Progress on Implementation As at 22 June 2007
<p>8. Improving transparency in respect of the Enforcement Department (paragraphs 73-81)</p>	<p>The Exchange is recommended to communicate to the market :</p> <p>(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</p> <p>(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.</p>	<p>LED</p>	<p>Completed</p>	<p>100%</p>	<p>The matter was duly considered and endorsed by the Listing Committee at its policy meeting on 23 April 2007. A public statement will be issued today.</p>

Appendix 2 – Summary of the results of the survey of the Listing Committee members and market participants’ view of the Exchange’s performance

The table below sets out the weighted average scores given by the survey respondents. The respondents were asked to rate the Exchange’s performance in various key areas on a scale of 1 to 5 with “5” being wholly satisfied and “1” being wholly dissatisfied.

		2006	2007
Views on the Exchange’s performance in its regulation of listing related matters			
1.	Communications to the market of the Exchange’s policies and practices under the Listing Rules	3.0	3.4
2.	Timely response to the market developments	3.1	3.3
3.	Acting in the interests of the investing public	3.6	3.9
4.	Provision of a fair, orderly and efficient market for the trading of the securities	4.0	3.9
5.	Ensuring that investors are kept fully informed of price sensitive information by listed companies on a timely basis	3.9	3.9
6.	Equal and fair treatment of all holders of listed companies	3.7	3.6
7.	Quality of companies listed in 2006	3.5	3.9
Views on the Listing Division’s performance			
8.	Consistency in decision-making	3.5	3.5
9.	Impartiality	3.9	3.8
10.	Timeliness of responses	3.3	3.6
11.	Pertinence of enquiries and comments raised during the vetting process or investigation process	3.3	3.5
12.	Experience and knowledge of the Listing Rules as regards its understanding of the policy issues behind the Listing Rules	3.6	3.9
13.	Experience and knowledge of the Listing Rules as regards its understanding of the requirements of the relevant provisions in the Listing Rules	3.9	3.9

Appendix 2 – Summary of the results of the survey of the Listing Committee members and market participants’ view of the Exchange’s performance

		2006	2007
Views on the various aspects of the IPO and C&M Departments’ work			
14.	Handling general enquiries	3.3	3.6
15.	Handling requests for guidance on the application of a particular Listing Rule	3.1	3.5
16.	Processing applications for waivers	3.4	3.6
17.	Processing listing applications	3.5	3.6
18.	Clearing draft announcements, circulars and other corporate information	3.4	3.7
19.	Handling complaints	3.2	3.5
20.	Handling short term suspension	3.2	3.4
21.	Handling long term suspension	3.2	3.3
Views on the quality of disclosure documents vetted by the Exchange			
22.	Clarity of prospectuses, announcements, circulars and other corporate information	3.4	3.6
23.	The relevant documents provide sufficient information to enable investors and shareholders (where relevant) to make properly informed assessment of the relevant issuer	3.6	3.7
24.	The relevant documents are easy to understand	3.1	3.2
25.	Timely issue of announcements and circulars	3.6	3.7
Views on the Exchange’s performance in monitoring compliance with and enforcement of the Listing Rules			
26.	Monitoring compliance with the Listing Rules by listed companies and directors	3.5	3.6
27.	Timeliness of disciplinary action taken against listed companies and directors	2.5	2.9
28.	Transparency of policy on disciplinary actions	2.8	3.1

Appendix 2 – Summary of the results of the survey of the Listing Committee members and market participants’ view of the Exchange’s performance

		2006	2007
Views on the Exchange’s policies and practices under the Listing Rules			
29.	The Exchange’s short term suspension policy is appropriate	3.5	3.7
30.	The Exchange’s long term suspension policy is appropriate	3.2	3.5
31.	The Listing Division has clearly communicated its approach to pre-vetting listed companies’ announcements, circulars and listing documents.	3.1	3.4
Overall average scores		3.4	3.6