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

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

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

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

Some in the middle felt that the existing system needed reform to deliver the stated consultation goals of better efficiency, accountability and transparency in listing regulation. But some were also skeptical about whether the two joint SFC and Exchange committees at the heart of the proposals – one to drive policy and the other to decide on listings with so-called “suitability” concerns – would actually help.

Since then a lot of water has gone under the bridge. Most importantly, over the last few months, the SFC has pursued a very different approach to the way in which it regulates listed companies. And more recently, the Exchange has issued a concept paper which outlines its ideas about a New Board for new economy companies.

Note: This is the speech as drafted and may differ from the one delivered.

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

Listing Regulation

What's the problem?

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

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

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

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

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

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

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

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

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

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

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

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

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

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

And I think we can all agree that reputational damage to the overall market can be very significant even if serious problems only relate to a minority of companies. You only have to look at the local and international press coverage of the extreme volatility in some of the interconnected small cap stocks I referred to earlier to see how true this is.

A rethink

In light of this, and against a background characterised by an accumulation of serious governance and misconduct issues, we decided to have a fundamental rethink.

We looked at the issue from every angle, making a big effort across our operating divisions to re-examine all of the existing regulatory tools at our disposal. We looked at how, if used differently and in different combinations, these tools might have far greater positive impact through the whole listed company life-cycle.

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

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

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

Front-loaded regulation

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

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

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

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

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

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

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

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

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

In some cases, a company's market capitalisation might increase by 10 times or more within a short period, but nothing in its financial performance or business model could possibly explain such a dramatic rise.

We have also seen stocks with sudden, sharp and inexplicable price declines. In some cases very high shareholding concentrations had minimised the real public float, or the level of trading interest fell significantly not long after an IPO. Share pledges to brokers by controlling shareholders to support margin loans can also play a role.

These conditions are also the setting for deeper concerns about misconduct. This can include schemes designed to artificially inflate or deflate share prices as well as other forms of price manipulation, money laundering, rigged shareholder votes and the use of misleading financial statements as well as accounting fraud. Accounting fraud can occur at the IPO stage or any time after listing.

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

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

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

While enforcement is a vital aspect of market regulation, many enforcement actions inevitably take time to pursue and often cannot undo the damage that has been caused, which means they may not always be the most effective way to tackle urgent market problems.

This is why, "front loaded", early intervention is so important. But what does this really mean? The market certainly deserves a clear explanation of how we are developing this idea in the listed company sector, and that's what I'll try to do now.

Targeted intervention

SMLR

The starting point is the "Statutory Listing Rules" under the Securities and Futures Ordinance (SFO) – referred to by the acronym "SMLR[2]". These little known rules – at least compared to the Exchange's Listing Rules – in fact give the SFC a solid basis to pursue more direct ways to tackle the more pressing issues in Hong Kong's listed market.

The SMLR basically enable the SFC to object to an IPO based on a set of specific legal grounds. These include indications of serious disclosure failures as well as the public interest. They also allow us to object on the same grounds to some capital raising proposals by companies that are already listed.

On top of this, they allow us to suspend trading in a company's shares in order to protect the wider investing public. In some circumstances, they enable us to direct the Exchange to delist a company after a suspension.

At the moment these rules play a role in the dual filing system, which has been in place for many years.

Many public responses to the joint consultation expressed a view that, instead of – or as well as – the Exchange and the SFC working together through new committees focused on the Exchange's Listing Rules, the SFC could have a fresh look at how it can independently use these types of powers to deal with the more serious issues in the listed company sector.

These responses were another catalyst for our examination of how we might use the SMLR far more expansively than is now the case under the dual filing system.

[2] The Securities and Futures (Stock Market Listing) Rules.

The first public demonstration of this was early this year, when we brought a more direct approach to bear on some deep-seated problems with GEM listings.

Poorly managed placing-only IPOs had long been a breeding ground for extreme share-price volatility or worse.

So we decided to issue new guidance on the obligations of sponsors, underwriters and placing agents when managing this type of IPO. We also issued a related joint statement with the Exchange targeting company directors on the same issue.

The basic message was – "if you ignore this guidance, the SFC may well intervene and object to your IPO under the SMLR, and if it becomes clear afterwards that a mismanaged placing has led to a disorderly market, expect a suspension of trading, and possible SFO sanctions to follow".

And importantly we then followed up by applying these guidelines in specific cases.

This had an immediate impact, causing some companies to delay sub-standard listing plans, and others to include a public offer to achieve a wider spread of genuine shareholders.

And this also showed that we didn't always have to hold off for potential Listing Rules changes to slowly work their way through the system to achieve some positive changes in market behaviour.

I should also say that underlying the need for a quick, flexible and focused approach is the fact that some market players adjust very quickly to regulatory actions.

Already, we are detecting similar problems in a different context as some change their IPO strategies in order to work around SFC concerns. Just two days ago, the SFC objected to a GEM IPO under the SMLR because of concerns about an exceptionally high shareholding concentration despite the fact that it was marketed entirely through a public offer.

We also wanted to make it very clear that when we object to a listing or even suspend trading, we will do so in an entirely transparent and accountable manner.

This meant early, direct communication with the company involved instead of routing our concerns via the Exchange, as was one of the conventions under the dual filing system.

We have used the SMLR to formally indicate our intention to object under the SMLR to three listings so far this year.

In one case, we were concerned about the company's relationship and dealings with its largest supplier. It appeared that we had been given false information about this, so we issued a formal letter to its board via the IPO sponsor indicating our intention to object to the listing. The company withdrew its IPO application shortly afterwards.

In another example, it was clear that the company's financial track record could not be a reliable basis for investors to even start to assess its potential performance after listing. This was because the company was heavily dependent on business referrals and operational support from a director and his private company, which he would subsequently sell. Again we issued a formal letter of our intention to object.

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

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

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

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

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

Guidance to the market

As well as this type of direct, company-focused intervention, we have also started to issue thematic guidance on how we intend to deal with specific issues under the SMLR and the other parts of the SFO relevant to listing.

I've already mentioned our guidance about GEM IPOs, which we then implemented directly case by case.

Another example was our recent guidance about valuations in corporate transactions.

In essence, this made plain that directors and independent financial advisers have a clear responsibility to make sure that professional valuers engaged by listed companies cannot be allowed to use unrealistic valuation assumptions to justify acquisitions or disposals at unsupportable prices.

We would consider any failure by a director to act properly in this circumstance to be a serious breach of duty, and would likely investigate and possibly seek disqualification or compensation orders.

We also issued a statement in April about potential IPOs by Belt and Road infrastructure companies. This was done to explain how we would view these companies under the SMLR from a broader policy perspective. Our aim here was very different, mainly to do with encouraging a new type of company to consider listing in Hong Kong. We wanted to explain how we would take a sustainable and measured approach to the question of country risk, and at the same time provide a clear pathway for these companies to list from a market development angle.

So we are using the SMLR more directly and more often, and we are issuing far more guidance to ensure that the market understands what we are paying special attention to.

But the final piece of the jigsaw is to explain *how* we are pursuing this strategy from an operational perspective, and what this means for the market.

Decision-making in listing matters

As you will have gathered, we are no longer acting behind the scenes, but instead we are increasing our direct presence when dealing with the more crucial listing matters that fall within the scope of the SMLR or the SFO.

This means that we are more routinely triggering our formal statutory gatekeeping and intervention powers so that we can interact directly with the market at an early stage. This also ensures that those affected will now be in a position to challenge our views to our face and to pursue statutory rights of appeal over any final decisions we make.

We believe that this more direct presence enables the SFO to be deployed far more effectively to drive market quality and market development, while at the same time ensuring that our decisions are made in a transparent, efficient, fair and accountable manner.

The Exchange will of course continue to make decisions under its Listing Rules – including decisions on suitability for listing. But the SFC's role has changed in some crucial respects.

Vetting of listing applications

First, when we assess listing applications, we will *only* consider whether they raise apparent concerns under the SMLR. The SMLR are concerned with the more serious disclosure and public interest issues, and this is where we will concentrate our resources from now on. I've already given some real life examples of the sort of issues we focus on.

The upshot is that the Exchange will remain the single point of contact with the market on Listing Rules disclosure, but not in relation to concerns we raise under the SMLR. This also means that we will no longer relay our comments on listing applications via the Exchange.

Second, to make sure this process is fair and transparent, when it becomes clear to us that we are likely to raise an objection to a listing, we will *always* issue a formal "letter of mindedness" to object to the listing. This will set out our concerns in detail and give the company an opportunity to challenge these before any final decision is made.

Third, the SFC will be the single point of contact on issues we raise under the SMLR. This is because it is only fair that companies and their advisers should be able to communicate directly with any regulator which takes action under the rules it is responsible for.

Fourth, we will always give detailed reasons for our views to enable the company to respond properly. And if the matter can't be resolved, and we proceed to formally object to a listing by issuing a final decision notice, this will immediately trigger statutory rights of appeal to the independent Securities and Futures Appeals Tribunal.

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

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

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

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

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

Post-IPO

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

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

Where possible, we will follow a similar approach if we intend to suspend trading under the SMLR – a letter will normally be issued asking the company to explain why a suspension shouldn't take place before any final decision is made.

Transparency

We have discussed these changes with the Exchange, and we also want the broader market to understand in detail the reasons why we have taken action under the SMLR and the SFO in specific cases. To that end, starting today, we will publish a new, regular bulletin which will summarise what we have done and why we did it.

New Board

I said at the beginning that I would touch on the Exchange's concept paper about a possible New Board. As the consultation is still underway, I'll confine myself to a few high-level observations.

First, there is no doubt that Hong Kong needs to look at how to reposition its listed market.

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

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

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

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

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

So a big challenge is to redress these structural imbalances so there is a healthier level of supply of interesting companies at the top end and greater demand by investors for more diverse companies at the lower end.

The open question is whether the New Board might help achieve this.

First, is the New Board the best way to accommodate companies with weighted voting rights which would otherwise qualify for the Main Board? Would this adversely affect market liquidity? And linked to this would or should index providers such as MSCI and FTSE exclude New Board companies from their indices, given that this is a key rationale for the proposal?

Second, instead of a New Board for companies with weighted voting rights, should Hong Kong bite the bullet and decide once and for all on the complex issue of weighted voting right structures that may or may not be acceptable for the Main Board? This suggests an open discussion about the merits and demerits of dual class shares from a governance perspective and how they may or may not be relevant to the competitive position of Hong Kong compared with other markets.

Alternatively, should weighted voting rights only be available to companies seeking a secondary listing in Hong Kong?

Third, turning to the New Board Pro for smaller or pre-profit companies, is there a consensus on the tradeoff between "light touch" regulation as proposed and the inevitable increased risk for investors? Of relevance here is the possibility that eligible investors would include individuals with $8 million portfolios (who may or may not be able to understand the risks) and the likelihood that institutional investors may only be interested in a few pre-profit companies with rich valuations.

Fourth, and more broadly, should Hong Kong pursue the idea of including international companies in Stock Connect, and even allow companies listing in Hong Kong to offer shares to Mainland investors?

Fifth, how does the New Board affect the competitiveness and positioning of GEM and the Main Board?

And finally, how can the New Board be set up mainly to attract so-called new economy companies?

These are just a few thoughts for debate, and of course we look forward to a well-informed, and wide-ranging public discussion on the New Board concept.

Conclusion

I'll wrap up now.

Last year's joint consultation on listing regulation was an incredibly valuable exercise which among other factors caused the SFC to reflect on its own role. Many of the responses to the consultation helped us enormously in doing this.

We now think that we are operating in a way which has a more positive impact on market quality.

So far as the joint consultation is concerned, we will continue to work on final conclusions together with the Exchange, which will now need to take account of the way in which the SFC has changed the way in which it carries out its job.

When we started to implement our new way of doing things a few months ago, I made a point of ensuring that our operating divisions realised that from then on, they would be far more accountable for their work.

This is particularly the case for the Corporate Finance Division, which, with the Enforcement and Intermediaries divisions, is now at the front line when making decisions under the SMLR. It needs to explain those decisions to the market, interact directly with affected companies, be tested by market reaction to our decisions and be alive to the prospect of formal appeals challenging its decisions.

I'm glad to say that all our staff welcome this new responsibility.

This is as it should be, and I'm confident that these changes will make a major contribution to Hong Kong's expansion as a financial centre in the years to come.

Thank you.