Submission to the
Panel of Inquiry on Penny Stocks Incident

by

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Dear Sirs,

Thank you for your letter of 8-Aug-02. I am pleased to respond as follows.

1. Nature of Enquiry

I should first comment on the title of your inquiry, "on Penny Stocks Incident".

1.1 Terms of reference

The terms of reference stated in your letter seem restricted to the method of amending rules and regulations, including the preparation and release of consultation papers, or any other form of consultation. The scope of your inquiry does not appear to extend to the content, rationale or reasonableness of the proposals in this particular "Incident". This is unfortunate, rather like examining how the Hindenberg was launched rather than what was inside it.

I believe your enquiry cannot be complete without examining whether a person who is presumed to have market experience (including those at the HKEx, SFC and Financial Services Bureau) could reasonably have anticipated how investors would react. Accordingly, before turning to the launch of this airship, we must comment on why the passengers all headed for the exits.

1.2 Dangerous proposals

While the title of your inquiry includes the term "Penny Stocks", the threat of delisting of stocks below $0.50, or whatever the chosen threshold, is in reality the least of investors' concerns. So-called "Penny Stocks" can easily become "Dollar Stocks" by consolidating their shares, and no doubt would do so. The far more dangerous aspects to the proposals are those which threaten delisting on criteria which cannot easily be remedied, if at all. For example, any company with an adverse audit opinion (whatever "adverse" means) would be delisted, as would any company with a market cap below HK$30m, or below $50m if it has made losses for 3 consecutive years. A company in that situation, whether it is priced in pennies or dollars, would still be delisted. These stocks are better termed "micro-caps".

I describe these proposals as "dangerous" for the simple reason that the effect of delisting would be to penalise minority shareholders, through no fault of theirs. The Stock Exchange of Hong Kong Limited (**SEHK**), under Section 27 of the Stock Exchanges Unification Ordinance (**SEUO**), has a legally protected monopoly to *"establish, operate and maintain a stock market in Hong Kong."* Accordingly, a delisting leaves minority shareholders without a market place in which to trade. Even worse, a delisting removes the shelter from abuse offered by the Rules Governing the Listing of Securities of the SEHK (**Listing Rules**). These include more frequent and deeper disclosure than is required by company law, both financial and transactional. Such transactions include connected transactions between a company and its controlling shareholder. Like a leaky umbrella, the Listing Rules may not be that great, particularly when the rain comes in sideways, but they are a lot better than nothing.

It is obvious that if you are about to lose something of value (a trading facility and regulatory protection) then your shares are worth less than otherwise, and the rational response is to sell until the risk is reflected in the price. Any company which got close to such criteria (in terms of market cap, or the other tests) would come under tremendous selling pressure. The announcement of an adverse audit report, triggering a delisting, would cause a share price to crash for the same reason.

1.3 Duty to the public

I believe that the SEHK, once a company has been admitted to listing, should provide a market place for public investors in that stock until it is either bankrupt or privatized, at which point there is no further need for the market. We already have rules which deal with these two scenarios. The delisting procedure for bankrupt companies could indeed by accelerated. There is nothing to stop them reapplying for listing if they are subsequently rescued, and indeed most so-called "backdoor listings" involving the shells of such companies do already involve a fresh application for listing.

For companies which are not bankrupt, in the spirit of transparency, it would be fine to tag stocks which no longer meet specified criteria as "sick", perhaps with a symbol or special stock code on the trading system, indicating the higher degree of risk. We already do this by coding all GEM stocks to begin with an "8". However, if we are to call distressed stocks a "third board" or "unlisted" market, then that market must still provide a transparent and orderly trading facility and the same degree of regulatory oversight to which other listed companies are subject. In other words, it would be a duplication of the existing SEHK. The degree of cost involved in establishing a duplicate of the SEHK makes this unviable. Accordingly, the conclusion is that SEHK should remain the market for distressed stocks as well as healthy ones. Winners and losers make a market.

1.4 Conflict of interest

It should be noted that HKEx has a financial interest in the delisting proposals. Think of listed companies as customers. The top 100 (by market cap) generate about 90% of the transaction, clearing and settlement revenues and constitute 90% of total market cap. The other 800 companies constitute 10% of such revenues and market cap. At the bottom end come distressed companies which generate abnormally high amounts of announcements, shareholder circulars, restructuring documents and so on, all of which must be vetted by SEHK's Listing Division. Clearly then, these customers create losses for HKEx and it would make higher profits without them. Indeed, there are probably no profitable "customers" outside the top 100 listed companies. In short, the HKEx delisting proposals are self-serving.

As a monopoly, or even if it were just a dominant provider, HKEx should have a "universal service obligation" to all customers – like an electricity or phone company, it cannot choose to service only those customers who are profitable to its business.

While HKEx claims a "Chinese Wall" between the Listing Division and the rest of the business of HKEx, there is no escaping the fact that the staff and other resources are paid for from a group budget funded by group revenues, and its expenses are part of the group income statement. In short, there is a direct and inescapable conflict of interest between being a regulator and a for-profit company.

1.5 Stock Manipulation

It may or may not be true that there was a concerted effort to dump stocks on 26-Jul-02. I find that irrelevant to your inquiry. Whether or not such manipulation was occurring that day (as it often does on any day), it is certainly the case that a rational investor, when faced with a likelihood that his or her stock will be delisted, will be strongly inclined to sell that stock, driving prices lower. The only person who would be a natural buyer of such stock is the person who would control the delisted company, since they have no risk of self-abuse, at least not as a shareholder. Some may even

"engineer" a delisting by satisfying one of the criteria, forcing the minorities to take whatever they can get.

I note with interest that the Legislative Council Financial Affairs Panel (**LCFAP**) met to review the Incident on 31-Jul-02. It is unlikely to be a coincidence that "sources" told the South China Morning Post (**SCMP**) in time for an article that morning, that the SFC has launched an investigation into the sell-off. Perhaps another investigation should be launched into whether anyone breached the secrecy provisions of Section 59 of the Securities and Futures Commission Ordinance (**SFCO**).

The SEHK cited manipulation of stock prices as a reason for one of its delisting criteria (para 130 of the Consultation Paper). Manipulation of stock prices and volumes is a fact of life in every stock market and cannot be eliminated by delisting micro-caps. On *Webb-site.com* I have written about several cases involving market capitalisations measured in HK$ billions. Almost by definition, a ramped stock is likely to have a market cap well above the delisting threshold, until it crashes, at which point the losses are already suffered. The correct approach to reducing manipulation is to reduce the potential to profit from it, which means reducing the number of investors who get sucked into over-priced stocks, which in turn means increasing the depth, frequency and accessibility of information to investors. A more informed investor is a less gullible investor.

1.6 Corporate Governance

The HKEx has claimed that the delisting criteria are necessary to improve the "quality" of the market and implicitly the corporate governance of listed issuers. There is no evidence to support this. Bad governance is almost always caused by bad management (who are normally the controlling shareholders), and almost never by minority shareholders. Why then, should proposals which have the principal effect of penalizing minority shareholders by delisting their shares, have any deterrent effect on bad management? In fact, these proposals would create another opportunity for a controlling shareholder to extract value by triggering a delisting and making a discounted general offer.

The answer to air pollution is not to hand out gas masks to every citizen, but to penalise the polluters in a manner sufficient to provide a credible deterrent to pollution. In corporate governance, that means penalizing directors who break the Listing Rules, not just privately or publicly reprimanding them, but fining them material amounts. The SEHK is not the proper person to be given such statutory powers, and this is another reason why the Listing and regulation of listed companies should be transferred to the SFC, which should be given statutory backing for the Listing Rules.

In the UK, when the London Stock Exchange was demutualised, the Listing Authority was transferred to the Financial Services Authority, which was given statutory backing. In short, it can fine directors for breaching the Listing Rules. The LSE is now in the business of providing efficient trading and pricing to its users, and not in the "business of regulation" – a term which is an oxymoron. The UK has no delisting criteria of the type proposed, and yet is generally recognised to have amongst the highest corporate governance standards in the World. Clearly, such delisting criteria are not necessary for a high quality market as the HKEx claims.

The SFC has powers under Section 45 and Section 37A of the SFCO (in the latter case after consultation with the Financial Secretary) to intervene to defend minority interests, seeking either a winding up (s45) or an alternative remedy (s37A) in cases of

unfair prejudice, but it has consistently failed to use these powers since the case involving Mandarin Resources which began in 1996. It remains to be seen whether the SFC will be any more aggressive in intervening to defend shareholder interests after using the strengthened powers of investigation under the new Securities & Futures Ordinance.

Furthermore, the Financial Secretary has the power to seek a winding up under Section 147 of the Companies Ordinance or an alternative remedy under Section 168A based on an Inspector's Report under that Ordinance. So far as I am aware, there has been no use of these powers in recent years, but there are surely cases which warrant it.

There also appears to me to be a lack of co-ordination between the SFC, the Commercial Crime Bureau and the ICAC. It is not clear to the public, in cases of suspected corporate fraud, to whom they should report the case. Furthermore, it is not clear to the public whether if one agency concludes that it cannot act, that it will pass the case to another agency or just file it. Greater clarity is needed.

While regulators show no sign of exercising their powers of intervention, the Government has also declined to empower shareholders with class action rights, or to provide a quasi-class action system by enabling the HAMS proposal to establish a levy-funded shareholder representation group. The HAMS proposal included an enforcement division which would conduct civil actions against offending parties as joint actions on behalf of hundreds or thousands of members in each company affected, simulating a class action. The courts will never be affordable to individual investors acting alone, as the size of their claims does not justify the expense. So shareholders are unable to play a role in providing a deterrent to abuse. This is a great shame, because the burden of providing a deterrent to bad governance is then left solely with Government agencies and the SEHK.

2. The SFC Shareholders Group

2.1 Background

On 28-May-01, the SFC announced the formation of a new "Shareholders Group" *"to provide advice and feedback to the SFC on issues relating to shareholders rights and interests"*. I have been a member of that group since its formation.

On 12-Jun-02, the SFC announced that it had reconstituted and formalized the Shareholders Group as a standing committee under section 6 of the SFCO. This followed observations from myself and other members that the original composition was more of a "cross-industry" group than a shareholders group, and that to provide more effective feedback on shareholder interests, it should be composed principally of those with shareholder interests.

The Shareholders Group, as currently constituted, is the first and only entity set up under Government auspices which reflects investor interests. By comparison, the SEHK/HKEx has no such entity. The main board Listing Committee, comprising 25 members including the Chief Executive of HKEx, can have a maximum of only 4 fund managers. Almost all the other members either represent listed issuers or get a substantial portion of their revenues from such issuers (including brokers/ sponsors, investment bankers, accountants and lawyers). The Listing Committee's behaviour reflects its composition, and it cannot be said to represent the best interests of investors. For more on this problem, including comments on the revised Listing Regime, see Listing Chaos (28-Jul-02) on *Webb-site.com*.

2.2 On Penny Stocks and Continuing Listing Conditions

On 6-Mar-02, at its 5th meeting (prior to such reconstitution), the Shareholders Group discussed a paper prepared by the Corporate Finance Division of the SFC dated 27-Feb-02 and entitled *"Penny Stocks and Continuing Listing Conditions"* which had 3 appendices.

I trust that the SFC will provide to you a copy of that paper, its appendices, the agenda and the minutes of the meeting if it has not already done so. I believe I am governed by the secrecy provisions of Section 59 of the SFCO, and understand that as your Panel is not a formal Commission of Enquiry with statutory powers, I may not be protected in providing evidence to you. However, in the public interest I am notifying you of the existence of these materials. Should I receive necessary clearance to discuss the materials with you, I would be pleased to do so.

So far as I know, the SFC had not seen any delisting proposals from SEHK at that stage, and if they had, those proposals certainly were not communicated to the Shareholders Group. This is consistent with the statement of the Chief Executive of HKEx to LCFAP in which he recorded that the HKEx and SFC did not discuss delisting procedures until 30-Apr-02.

I have made inquiry of the SFC and was informed that although they took into account the views expressed by members of the Shareholders Group, they did not represent these views directly to SEHK as views of the Shareholders Group.

This may be due to an earlier episode, in which the Shareholders Group, in its 3rd meeting (22-Nov-01) and 4th meeting (29-Nov-01) reviewed the internal proposals of SEHK for amendments to the Listing Rules regarding corporate governance. We were not shown the draft consultation paper but were advised of its content, and gave our views. These views were then communicated by two letters from the SFC to SEHK. I understand that the SEHK reacted negatively to the fact that the Shareholders Group had been consulted on this matter, in advance of the proposals being finalized and made public. Personally, I think the SFC was entirely within its rights to consult us, and indeed the Shareholders Group would be rather pointless if it had no role in advising on policy formation.

In the event, it was obvious from the final Consultation Paper published in Jan-02 that the views of the Shareholders Group had been largely ignored, and some of the SEHK's internal proposals had been watered down, I presume by the Listing Committee. Perhaps for that reason, the SEHK does not want the SFC to consult the Shareholders Group on such draft proposals in future. I hope they will, as seeking the views of investors in this confidential forum should lead to proposals which are more closely aligned with investor interests.

Your Panel of Inquiry may wish to make recommendations to require that the Shareholders Group be consulted, either directly or via the SFC, on proposals which may affect shareholders, and that the group's views be taken into account when formulating proposals. Had the SEHK obtained those views on this occasion, and if those views had been reflected in the proposals, then they would have been very different to their published form. Of course, if the views had been obtained and ignored, then it would have made no difference.

3. The Relationship between the SFC and SEHK/HKEx

For the purposes of this section, I will assume that the SEHK shall remain the entity which promulgates and administers the Listing Rules, although as I have said separately, this should be placed in the hands of the SFC.

One of the fundamental problems in the crafting of the Listing Rules is that under Section 34 of SEUO, the SEHK makes the Listing Rules, and under Section 35 of SEUO, the SFC can only approve or reject changes to those rules. It cannot direct that changes be made.

The only circumstance in which this would cease to be the case is if the SFC were to exercise its powers under Section 14 of the Securities Ordinance to superimpose its own listing rules, in which case the SEHK's Listing Rules would continue in effect as long as the are not *"repugnant to any rule made by the [SFC]"*. In 1991 the SEHK and SFC signed a *Memorandum of Understanding Governing Listing Matters*, which was updated on 6-Mar-00 to reflect the reorganization which created HKEx (the **MoU**). Under this MoU, the SFC reserved the right to exercise its Section 14 powers if the SEHK failed to comply with the MoU. The implication is that otherwise, these powers will not be exercised. So far, they never have been.

The fact that the SFC can only approve or reject changes to the Listing Rules, but not direct that changes be made, leaves an excessive amount of power with SEHK. It leads to incredibly slow reform of the Listing Rules, since reform is usually in the direction of tightening regulation in favour of investor protection rather than issuer freedom. Accordingly, SEHK can simply do nothing rather than accept reforms which its issuer-based Listing Committees find too inconvenient for issuers.

To take an example, after the GEM Listing Committee began waiving the rules in a wholesale fashion in early 2000, which had the effect of amending the rules without SFC approval, questions were asked in the press and Legislative Council and eventually a standstill was reached on 11-Mar-00 between SEHK and SFC. There would be an agreed set of waivers, and no new waivers, pending a market consultation on the rules. A consultation paper was published on 23-May-00, and the consultation period closed on 30-Jun-00. It then took almost 13 months while the SEHK and SFC negotiated and compromised on rules changes, before announcing the outcome on 27-Jul-01. Hong Kong cannot go on making its rules in this farcical manner – it again underlines the need for a single point of Listing Rules regulation under the SFC.

4. The Relationship between the Government and the SFC

It is my general observation that in negotiations between SEHK and the SFC, SEHK has the upper hand, both because of inertia (it can simply do nothing rather than accept tighter rules) and because the SFC lacks a strong enough mandate from the Government, which tends to have a closer ear to the large listed issuers of Hong Kong. The pretence that the SFC is an "independent" statutory body is contradicted by the fact that the Chief Executive of Hong Kong appoints and can remove the Directors of the SFC under Section 5 of the SFCO. To most outsiders, the SFC is subordinate to Government, and boat-rockers are not welcome.

As a matter of law, the SFC has to consult with the Financial Secretary in a number of its activities, such as the use of s37A of the SFCO. Other matters, such as inquiries by the Insider Dealing Tribunals, are at the discretion of the Financial Secretary *"whether following representations by the [SFC] or otherwise"* - see Section 16 of the Securities

(Insider Dealing) Ordinance. The SFC is kept on a short leash by Government, and that means that the Government ultimately decides how far the SFC goes to pursue its remit

5. The Relationship between the Government and the HKEx/SEHK

5.1 De facto control of HKEx

Government has been at pains in this Incident to distance itself from the decision making process of HKEx. This disregards the fact that the Government has *de facto* control of HKEx,

Indeed, one must recall the catalyst behind the Government's Mar-99 proposal that SEHK, Hong Kong Futures Exchange Limited (**HKFE**) and Hong Kong Securities Clearing Company Limited (**HKSCC**) merge to create HKEx. This catalyst was that the Government found during its 1998 stock market intervention that it was unable to closely direct the affairs of SEHK and HKSCC, and in particular, that HKSCC was slow to enforce the T+2 settlement rules and thereby made it harder for Government to manipulate the market upwards (an offence for which it claimed "State" immunity). That episode was the final straw that made the Government act to rid Hong Kong of the private members club that had caused such embarrassment in 1987 when its Chairman shut the SEHK for a week and was subsequently jailed for unrelated offences.

Accordingly, when HKEx was created, numerous controls were put in place. Under Section 20 of the Exchanges and Clearing Houses (Merger) Ordinance (**ECHO**), the Government appoints 8 directors to the board of HKEx out of a total of 15, a majority control. Even after the 2003 Annual General Meeting, this number will be not less than the number appointed by the shareholders of HKEx.

In addition, under Section 11 of ECHO, the Chairman of HKEx must be approved by and can be removed by the Chief Executive of Hong Kong, while under Section 12 of ECHO, the Chief Executive and Chief Operating Officer of HKEx must be approved by the SFC, which is a government agency. As you know, the Chairman of HKEx, Mr Charles Lee, was until 30-Jun-02 an Executive Councillor, while the Chief Executive, Mr Kwong Ki-chi, was "recruited" by HKEx from the civil service, his last job having been Secretary for Information Technology and Broadcasting. He has a seat on the board of HKEx, making 9 out of 15 directors under Government appointment or approval.

5.2 Government involvement in Rule Making

I have heard claims by the Government that they have no involvement in proposing changes to the Listing Rules, which are simply a matter for the Listing Committee. In reality, this refuted by facts. Just one day before the proposals on delisting criteria were announced, on 24-Jul-02, the Government, HKEx and SFC jointly announced, in a press conference in Government offices, that changes would be made to the whole Listing regime, which will require extensive changes to the main board and GEM Listing Rules, in particular the chapters which set out the composition and powers of the various committees. Present at that press conference were the Secretary for Financial Services and the Treasury (**SFST**), the Chairman of HKEx, the Chief Executive of HKEx and the Chairman of the SFC. These changes in fact reversed proposals announced by HKEx on 6-May-02, before the SFST came into office on 1-Jul-02.

While it may be true that the management of HKEx and the Government do not choose to involve themselves in minor amendments to the Listing Rules, it is also true that

they can do so at any time. The Listing Committees of SEHK do not act in isolation. They normally only meet once a week, and the proposals put to them are crafted by the Listing Division of SEHK, a subsidiary of HKEx. The staff of the Listing Division report to the Chief Executive of HKEx.

Another example of Government exercising its control of HKEx is the decision to delay deregulation of brokerage commissions. Although it was clearly a government decision, the minimum commission rate is in fact set out in Rule 534 of the Rules of the Exchange, so amending that rule is theoretically a matter for the SEHK under Section 34 of SEUO, subject to SFC approval under Section 35.

6. The Government's Culpability

While it is true that the proposals in this Incident were made by HKEx who are accordingly liable, one cannot ignore the fact that the Secretary for Financial Services and the Treasury was in a position to know, and should have known, what the proposals contained. Not only that, but he should have understood the implications of the proposals. His years of experience in banking, listed companies and the markets equip him to do the job, unlike his predecessor.

These delisting proposals were foreshadowed at his own press conference the day before the delisting proposals were announced. It was clear from his reversal of the previously announced HKEx plans for a new Listing regime that he intended to take an active role in regulatory affairs, and no doubt if he had briefed himself on the proposals in advance, then he would have recognised their implications and intervened to stop them being published. Either that, or he is not interested in the impact on investors in affected companies (current and future) of removing the listing for their shares.

What the Government can learn from this is the need to take regulation out of HKEx, centralize the rule-making process under the SFC, and monitor regulatory proposals more closely.

7. Closing remarks

What is clear from this Incident is that HKEx is an incompetent and conflicted regulator. Either it was unable internally to predict the logical investor response to the proposals, or worse, it was able to predict the response, but pressed on in its own financial self-interest.

HKEx does not have a mechanism for externally assessing likely investor reactions to its proposals. The SFC has established such a mechanism in the Shareholders Group, but there is no connection between the Shareholders Group and the HKEx, and certainly no dialogue between the two.

HKEx put forward self-interested proposals which would have boosted its own profitability. These proposals originated at HKEx, not at the Listing Committee or the SFC.

Even if you accept the HKEx's position that the proposals were *bona fide* and aimed at improving the quality of the market (rather than getting rid of difficult and unprofitable customers), I believe that premise is misconceived and reflects a failure to comprehend the causes of bad governance in the first place. Dredging the toxic mud from the bottom of the harbour does not stop fresh pollution entering the harbour and killing more fish.

Whatever the conclusions you are able to reach within your narrow frame of reference, I hope you will be able to remark on the core problem, that we need a Listing framework which:

1. provides higher minimum standards of corporate governance in the Listing Rules;
2. is administered by a regulator, not a for-profit company; and
3. has statutory backing with meaningful financial penalties for management who break Listing Rules

Yours faithfully,

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