



**SECURITIES AND FUTURES COMMISSION**  
證券及期貨事務監察委員會

**Report on the Securities and Futures Commission's  
2015 annual review of the Exchange's performance  
in its regulation of listing matters**

June 2016

# Table of Contents

<b>Executive summary</b>	<b>1</b>
<b>Section 1</b>	<b>2</b>
<b>Purpose and focus of our review</b>	<b>2</b>
<b>Our approach and scope</b>	<b>3</b>
<b>How we conducted the assessment</b>	<b>4</b>
<b>The assessment process</b>	<b>4</b>
<b>Overall assessment</b>	<b>5</b>
<b>Market perception of the Exchange's performance</b>	<b>5</b>
<b>Section 2</b>	<b>6</b>
<b>Observations on the Listing Department's performance</b>	<b>6</b>
<b>Level of activities</b>	<b>6</b>
<b>Issuance of guidance relating to the Listing Rules</b>	<b>8</b>
<b>Reverse takeover transactions</b>	<b>12</b>
<b>Liquidity provision performance of structured products issuers</b>	<b>13</b>
<b>Recommendations</b>	<b>15</b>
<b>Appendix A</b>	<b>16</b>

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## Executive summary

1. This report summarises the key findings and recommendations of the Securities and Futures Commission's (SFC) 2015 annual review regarding the performance of The Stock Exchange of Hong Kong Limited (Exchange) in its regulation of listing matters during 2014.
2. We reviewed the Exchange's operational procedures and decision-making processes in each of the Listing Department's operational teams to assess whether they are adequate to enable the Exchange to meet its statutory obligation under section 21 of the Securities and Futures Ordinance (SFO). The Exchange has a statutory obligation under section 21 to ensure, as far as reasonably practicable, an orderly, informed and fair market.
3. We are of the view that, other than in respect of certain procedures involving issuance of guidance to the market as detailed under the section headed "Issuance of guidance relating to the Listing Rules" below, the Exchange's operational procedures and decision-making processes in each of the Listing Department's operational teams as described in the "Our approach and scope" Section below, were appropriate to enable the Exchange to discharge its statutory obligation under section 21 of the SFO during the review period.
4. We are satisfied that the Exchange has taken steps to address the recommendations in our 2014 report.
5. This report is set out as follows:
  - (a) Section 1 explains the scope, purpose and focus of our review and the review process;
  - (b) Section 2 sets out our assessment and recommendations in respect of our review of the Exchange's operational procedures and decision-making processes in each of the Listing Department's operational teams to assess whether they are adequate to enable the Exchange to meet its statutory obligation under section 21 of the SFO; and
  - (c) Appendix A provides a profile of the respondents to our survey of the Listing Committee members' and market participants' views on the Exchange's performance and a summary of the results of the survey.
6. We wish to thank members of the Listing Committee and Listing Department staff for their assistance provided to us in the review process.



## Section 1

### Purpose and focus of our review

7. The SFC has a statutory duty under section 5(1)(b) of the SFO to supervise, monitor and regulate the activities carried on by the Exchange. As set out in the Memorandum of Understanding between the Exchange and the SFC dated 28 January 2003 (Listing Matters MOU), we have agreed with the Exchange that we should periodically review the Exchange's performance in its regulation of listing-related matters.
8. 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 before publication.
9. 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<sup>1</sup>.
10. 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 strength of staff in the Listing Department with an adequate level of professionalism and experience to discharge the responsibilities of the Listing Department.
11. Except for matters specifically reserved by the Listing Committee under the Listing Rules, most matters concerning the Listing Rules are dealt with by the Listing Department in the first instance. Matters dealt with by the Listing Department include processing listing applications, monitoring and enforcing listed companies' compliance with the Listing Rules.
12. 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.
13. The Exchange's statutory obligation under the SFO is on-going, 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 on-going compliance.
14. During the course of our review of the Exchange's performance, we may also make observations on current issues and changes in the Exchange's operational procedures and decision-making processes.

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<sup>1</sup> Section 21 of the SFO.



## Our approach and scope

15. Our review focused on the decision-making process and procedures in each of the operational teams in the Listing Department, and in particular the following areas (see Section 2 of this report):
  - (a) issuance of guidance relating to the Listing Rules;
  - (b) whether reverse takeover transactions were processed in accordance with the guidance letter issued by the Exchange in May 2014; and
  - (c) the Exchange's monitoring of liquidity provision performance of structured products issuers.
16. We reviewed the operations of the following teams in the Listing Department:
  - (a) the IPO Transactions Team (IPO Team) whose primary responsibility is to process new listing applications in respect of equity securities;
  - (b) the Compliance and Monitoring Team (C&M Team) which is responsible for monitoring listed companies' compliance with the Listing Rules;
  - (c) the Listing Enforcement Team (Enforcement Team) which investigates suspected breaches of the Listing Rules and institutes disciplinary action before the Listing Committee for such breaches by companies and their directors; and
  - (d) the Structured Products and Fixed Income Team (Structured Products Team) which is responsible for processing listing applications for debt and structured products, such as derivative warrants and callable bull/bear contracts (CBBCs).
17. We reviewed the Listing Department's laid down procedures and processes as a whole, supplemented by reviews of sample cases in order to understand how the Department's policies work in practice and to verify whether the Department's practices adhered to its policies.
18. As in previous years and as part of the review process, we interviewed members of the 2014/2015 Listing Committee. We also interviewed each of the heads of the operational teams, including the Head of Listing, to obtain an understanding of their assessment of the effectiveness and efficiency of their respective team's decision-making processes and operational procedures.



## How we conducted the assessment

19. In conducting our assessment, we considered:
- (a) relevant internal Exchange materials, written policies, procedures and processes documented by the relevant operational teams in the Listing Department and any general practices that have not been documented;
  - (b) sample cases, including the relevant operational teams' internal reports and case files;
  - (c) information we receive from the Listing Department in the ordinary course of our dealings with the Department, including its monthly report to us, internal reports and case data;
  - (d) the Hong Kong Exchanges and Clearing Limited (HKEX) 2014 annual report and the Listing Committee Report 2014;
  - (e) the Exchange's published disciplinary procedures, listing decisions, rejection letters, guidance letters, and other related documents on the HKEX website;
  - (f) discussions with Listing Committee members;
  - (g) discussions with senior management of the relevant operational teams in the Listing Department;
  - (h) comments made in interviews or discussions with the relevant case officers;
  - (i) our continuing interaction with the Exchange under the Listing Matters MOU; and
  - (j) a survey of market participants' views to gauge the market's perception of the Exchange's performance in its listing-related functions.

## The assessment process

20. 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 Matters MOU.
21. We discussed our findings with the Head of Listing.
22. We sought the Exchange's comments on both the factual matters set out in this report and our conclusions.
23. The field work and review process were completed in May 2015. Where relevant, we have also made observations on current issues and changes in the Exchange's operational procedures and decision-making processes in 2015.



## Overall assessment

24. We are of the view that, other than in respect of certain procedures involving issuance of guidance to the market as detailed under the section headed “Issuance of guidance relating to the Listing Rules” below, the Exchange’s operational procedures and decision-making processes in each of the Listing Department’s operational teams as described in the “Our approach and scope” section above, 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

25. As part of the review process, we conducted a survey of a number of market participants, including investment bankers, legal advisers, accountants, investors, 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.
26. Respondents were asked to rate the performance of the Exchange and each of the operational teams in the Listing Department in various key areas on a scale of 1 to 5 with “5” being wholly satisfied.
27. We sent a questionnaire on the Exchange’s performance to 162 (2014: 179) Listing Committee members and market practitioners and received 56 (2014: 72) responses. The response rate is 34.6% (2014: 40.2%). Overall, there is no significant change in the respondents’ view of the Exchange’s performance. The average overall score for the 2015 survey is 4.0 which is the same as that in 2014. Respondents are generally satisfied with the efficiency and fairness of the Exchange in its vetting process for listing and post listing matters. Please refer to Appendix A for a profile of the respondents and a detailed summary of the results of the survey.



## Section 2

### Observations on the Listing Department's performance

#### Level of activities

28. The following table indicates the level of activity in the four operational teams of the Listing Department in 2010, 2011, 2012, 2013 and 2014<sup>2</sup>.

	2010	2011	2012	2013	2014
Number of listing applications accepted by the IPO Team	204	247	141	177	194
Number of listing applications vetted by the IPO Team	235	286	205	227	232
Number of compliance and monitoring actions handled by the C&M Team <sup>3</sup>	39,823	39,393	48,395	49,103	58,450
Number of investigations handled by the Enforcement Team	133	142	91	69	60
Number of listing applications processed by the Structured Products Team <sup>4</sup>	14,367	12,251	11,942	16,212	17,543
- Derivative warrants	7,826	6,917	5,886	7,264	7,560
- Callable bull/bear Contracts (more commonly known as CBBCs)	6,541	5,334	6,056	8,948	9,983

29. The Listing Department assesses its efficiency or timeliness of its actions primarily by measuring its turnaround time. Each team has instituted performance pledges as to when they will complete a particular task to improve and ensure efficiency.

#### IPO Team

30. IPO Team vetted 232 listing applications in 2014, an increase of 5 listing applications or 2.2% from 2013. The average time between receipt of application and issue of first comment letter in 2014 was 10 business days (2013: 14 business days). The percentage of applicants reviewed by the Listing Committee within 120 days was 72% in 2014 compared to 54% in 2013.

31. IPO Team published and updated a number of guidance materials (e.g. guidance letters, frequently asked questions and checklists) to assist market participants in understanding and complying with the Listing Rules requirements.

<sup>2</sup> Source: HKEX 2014 Annual Report, pages 34 – 38.

<sup>3</sup> Compliance and monitoring actions include announcements and circulars vetted, share price and trading volume monitoring actions undertaken, press enquiries raised and complaints handled.

<sup>4</sup> The figures for 2014 related to new structured products issues and did not include further issues. The corresponding figures for previous years have been restated.





32. On 1 October 2014, the Listing Rules complementing the new sponsor regulation<sup>5</sup> came into full effect. In 2014, the Exchange made various enhancements to its guidance materials issued in July 2013 to clarify the requirements of the new regime. With the issuance of new and revised guidance and the streamlining of the IPO vetting process, the Exchange noted an improvement in the quality of the application proof submitted and a reduction in the vetting/processing time (see table below).

	<b>Time taken to process an application for hearing (in calendar days)</b>	<b>Return rate of listing applications<sup>6</sup></b>
1 October 2013 to 31 May 2014	115	11%
1 June 2014 to 31 January 2015	102	3%

#### C&M Team

33. C&M Team continued with its initiative to promote listed companies' self-compliance with the Listing Rules. In March 2014, the team amended the Listing Rules relating to connected transactions and published related guidance materials. The team also published guidance letters on key listing matters, including the application of reverse takeover requirements (30 May 2014), use of contractual arrangements for companies' businesses (23 May 2014), and opinion letters prepared by independent financial advisers under the Listing Rules (2 May 2014).
34. Post-vetting of announcements continued to form a significant part of C&M Team's work. In 2014, 2% (2013: 3%) of the post-vetted announcements resulted in remedial follow-up actions being taken by listed companies, mainly by publishing clarification announcements.
35. In terms of timeliness, the team:
- (a) post-vetted results announcements within five business day in 99% of the cases (2013: 98%);
  - (b) post-vetted other announcements within one business day in 98% of the cases (2013: 99%); and
  - (c) pre-vetted announcements within the same day in 98% of the cases (2013: 98%).

#### Enforcement Team

36. With the implementation in January 2013 of the statutory backing of the continuous obligation on listed companies to disclose inside information, responsibility for the enforcement of that obligation passed to the SFC.

<sup>5</sup> The new sponsor regime was implemented on 1 October 2013.

<sup>6</sup> The return rate is the number of applications returned by the Exchange expressed as a percentage of the total number of applications received.



37. In 2014, with the approval of the Listing Committee, the Enforcement Team has adopted the following five themes as the focus for its investigation going forward:
- (a) director's performance of fiduciary duties as required under the Listing Rules, particularly their exercise of care, skill and diligence in relation to asset disposal and acquisition;
  - (b) companies delinquent in publishing financial statements resulting from internal control deficiencies;
  - (c) circumstances leading to "heavily" qualified financial statements (i.e. with an adverse or disclaimer opinion by auditors) and directors' responsibilities;
  - (d) failure of companies (which are subject to prolonged trading suspension) and their directors to address the Exchange's concerns in a timely manner to procure trading resumption as soon as possible; and
  - (e) failure of companies and directors to co-operate with the Exchange's investigation.
38. Enforcement Team handled 60 investigations in 2014 (2013: 69). The department completed 6 (2013: 8) disciplinary cases, issued 14 (2013: 16) warning or caution letters and closed a further 12 (2013: 8) cases by way of "no further action". The Exchange considered that the decrease in the number of investigations in recent years to be mainly attributable to the implementation of the inside information regime in January 2013.

	<b>Investigations</b>	<b>Warning/Caution letters issued</b>	<b>Cases closed by way of "no further action"</b>	<b>Disciplinary cases</b>
<b>2010</b>	133	27	20	9
<b>2011</b>	142	42	26	9
<b>2012</b>	91	20	13	12
<b>2013</b>	69	16	8	8
<b>2014</b>	60	14	12	6

#### Debts and Derivatives Team

39. Debts and Derivatives Team saw an increase of 8.2% from 16,212 in 2013 to 17,543 in 2014 in the total number of derivative warrants and CBBCs listing applications processed.

#### Issuance of guidance relating to the Listing Rules

40. The Listing Rules consists of the Rules, Guidance/Practice Notes and Appendices. Changes to the Listing Rules must be recommended by the Listing Committee and endorsed by the Board of the Exchange. They have no effect unless approved by the SFC under section 24 of the SFO.
41. The Exchange also publishes on its website reference materials on its interpretation of, and guidance on, the Listing Rules. According to its website these materials do not form part of



the Rules, nor do they amend or vary any Rule requirements, or absolve issuers and/or their directors of any obligations to make their own judgment<sup>7</sup>.

42. A Listing Decision is normally issued to explain a decision made by the Listing Committee and/or the Listing Department. They are based on past cases handled by the Listing Committee or the Listing Department in light of the specific facts of the cases presented and available to them and may relate to a novel or controversial issue that has arisen in a transaction, be it during the course of considering an IPO application or an issuer's on-going corporate transaction, or an issue that has recurred frequently. The rationale for issuing a Listing Decision is to enhance transparency and market understanding of their interpretation of the Listing Rules in those cases. According to the Exchange each decision is made based on specific circumstances and is not a precedent for future cases<sup>8</sup>. This means that listing applicants, issuers, market practitioners and the Listing Department may refer to published Listing Decisions for reference or guidance, but the Exchange is not bound by decisions made in previous cases. The Exchange is of the view that Listing Decisions do not create or amend or vary the Listing Rules or listing policies.
43. As Listing Decisions crystallise the Exchange's practices, interpretations or views on specific Listing Rule requirements and market practitioners, sponsors and issuers customarily refer to the published Listing Decisions when considering the implications of particular Listing Rules, we are of the view that despite the Exchange's indication to the contrary, the decisions or views set out in the Listing Decisions become exceptions to or modifications of the Listing Rules and they are used as precedents by both market practitioners and the Exchange's staff.
44. The guidelines for decision-making contained in the C&M Manual<sup>9</sup> provide that matters, such as waiver applications, rule interpretations or decisions, which are routinely handled by the Listing Department at staff level, may be escalated to the Head of Listing or the Listing Committee if they are novel, controversial or if a regulatory concern cannot be properly addressed by strict application of the Rules. However, we noted that relatively few day-to-day matters such as waiver applications or rule interpretations or decisions are brought to the Listing Committee for its consideration and decision: they are routinely handled by the Listing Department at staff level<sup>10</sup>. Although the C&M Manual provides that these matters may be escalated to the Head of Listing or the Listing Committee if they are novel, controversial or if a regulatory concern cannot be properly addressed by strict application of the Rules, there is no guidance or mechanism for determining when such matters should be referred to the Committee for its consideration and endorsement.
45. In addition to Listing Decisions, the Exchange issues other interpretations and guidance in the form of guidance letters, frequently asked questions (FAQs) and other guidance materials such as practices and procedures for handling listing-related matters. The number of decisions, guidance and interpretative materials have grown over the years. For the period from 2010 to 2014, 127 Listing Decisions, 64 Guidance Letters, 23 other guidance materials and 21 FAQs were issued. A summary of the guidance materials published by the Exchange is set out in the table below.

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<sup>7</sup> Source: HKEX website: Rules and Regulations > Rules and Guidance on Listing Matters.

<sup>8</sup> Source: HKEX website: Rules and Regulations > Rules and Guidance on Listing Matters > Listing Decisions.

<sup>9</sup> The C&M Manual for professional staff which set out processes and procedures in respect of the work of the Compliance and Monitoring Team.

<sup>10</sup> The Listing Department considered 359 waiver applications relating to post-listing matters in 2014. Six (1.7% of the total) were considered by the Listing Committee.



	Issued in 2014	Issued in 2013	Issued in 2012	Issued in 2011	Issued in 2010
FAQs	5 series	6 series	2 series	4 series	4 series
Listing decisions (Note 1)	8	38 <sup>11</sup>	15	23	43
Guidance letters (Note 2)	10	24 <sup>12</sup>	21	2	7
Other guidance materials (Note 3)	6	9	4	0	4
<b>Total</b>	<b>29</b>	<b>77</b>	<b>42</b>	<b>29</b>	<b>58</b>

Note 1: Listing Decisions comprise decisions on specific cases handled by the Listing Committee and/or the Listing Department.

Note 2: Guidance letters give guidance on specific rule requirements.

Note 3: Other guidance materials contain general guidance and reference materials on the Listing Rules (e.g. Guide on the Exchange's practices and procedures for post-vetting announcements).

## Listing Decisions

46. In 2014, eight Listing Decisions were published. As part of our review, we looked at all of these Listing Decisions and a sample of Listing Decisions which had recently been updated.
47. In our review we found that, in a number of cases, the information set out in the Listing Decision was limited and too general, which may result in the outcomes being applied to circumstances which are materially different to those in the published decision. We noted from our review of Listing Decisions that in a number of cases relating to the Listing Department's on-going monitoring of listed issuers, for example in relation to issuers' corporate transactions, decisions were made exclusively by the Listing Department<sup>13</sup>. These decisions were subsequently published by way of Listing Decisions without the Listing Committee's oversight. In the eight Listing Decisions published in 2014, only one Listing Decision related to a matter considered by the Listing Committee. We are not aware that the Listing Committee has reviewed any of the other published Listing Decisions in 2014.
48. According to the Exchange the Listing Rules clearly set out the respective functions and powers of the Listing Committee and the Listing Department in respect of listing matters. In addition, the Listing Department has established internal guidelines and procedures to ensure its decisions on listing matters are made according to the powers and functions delegated by the Listing Committee to the Listing Department under the Rules. Both the Listing Committee and the Listing Department are satisfied that the function of publication of these guidance materials falls squarely within those of the Listing Department under Main Board Rule 2A.02 and GEM Rule 3.02. The Exchange explained that in drafting any Listing Decision the Listing Department would seek to include only the relevant and material information essential for the decision and the understanding of it. The Listing

<sup>11</sup> 13 out of 38 related to Chapter 18 of the Listing Rules (Mineral Companies).

<sup>12</sup> 10 out of 24 related to rule changes to complement new sponsor regulations; 5 out of 24 related to simplification series of the listing documents.

<sup>13</sup> Listing Decisions relating to IPO cases generally arise out of matters that have been considered and decided upon by the Listing Committee as such matters are routinely referred to the Committee.



Department is of the view that its Listing Decisions have provided adequate summaries of the facts and analysis of the underlying cases.

49. Highlighted is an example of the issues relating to Listing Decisions.

*LD8-2011 - Whether Company A must include convertible preference shares as part of its total issued share capital in calculating the public float of its listed shares*

50. Rule 8.08 requires at least 25% of an issuer's total issued share capital to be held by the public<sup>14</sup>.
51. In one case as set out in LD8-2011 (updated in 2014), the Exchange took the view that the issuer would not be required to include its non-listed convertible preference shares for the purpose of calculating public float. The reason given for this decision, as set out in the Listing Decision, was simply "...having considered the terms of the CPS, they were similar to debt securities". Limited information was provided and there was no analysis on how the Exchange arrived at its decision.
52. We looked into the facts (in particular the terms of the convertible preference shares) of this case and of similar cases that followed. We found that, apart from having a preference as to the distribution of capital upon liquidation, the convertible preference shares were in all material aspects akin to ordinary shares. The convertible preference shares ranked *pari passu* with the ordinary shares as to dividends which would be paid with respect to the ordinary shares on an "as converted" basis. Most of them were disclosed in the annual reports of the respective issuers as equity under share capital. The basis on which the Listing Department arrived at the conclusion that the preference shares in those cases were akin to debt securities is unclear.
53. This case was decided at the level of the Listing Department and the Listing Committee had not considered nor endorsed the decision. We note that it is now common for listed companies to issue convertible preference shares in an acquisition of assets where an issue of ordinary shares would reduce the public float below the limits set by the Listing Rules<sup>15</sup>.
54. The Listing Department explained that the case underlying LD8-2011 was decided in light of the specific facts of the case. It determined that the decision was neither novel nor controversial as it was consistent with its understanding of the policy intent of the public float Rules (that is, to ensure sufficient float of each class of *listed* securities would be available for trading) and followed the established practice prior to LD8-2011 publication.
55. Whilst acknowledging the Listing Department's explanation (see paragraph 48), we recommend that the Exchange reviews the process for determining when post-listing matters, such as waiver applications, rule interpretations or decisions should be escalated to the Listing Committee for its consideration and endorsement. Relevant information and the rationale for decisions should be clearly set out in published guidance materials to facilitate the public's understanding of the issues.

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<sup>14</sup> In April 2015 Rule 8.08 was amended to require at least 25% of the issuer's total number of issued shares to be held by the public.

<sup>15</sup> We understand the Exchange is conducting a review of the public float rules including the application of the rules to convertible preference shares.



## Reverse takeover transactions

56. In our 2013 report<sup>16</sup>, we reviewed the Exchange's processes and procedures in respect of reverse takeover transactions and recommended that the Exchange conducts a general review of the application and administration of the reverse takeover rules to ensure that the policy intention behind these rules is preserved.
57. Since then we have closely monitored the Exchange in its efforts to address our recommendations. We note that the Exchange has taken the following steps to tighten its approach in applying the reverse takeover rules.
58. In October 2013, the Listing Department submitted a discussion paper to the Listing Committee on its reverse takeover policy proposals and an analysis of the Listing Department's approach in applying the reverse takeover rules.
59. The Listing Committee considered the paper and, among others, concluded as follows:
  - (a) the Listing Department should continue with its current approach of progressively tightening the application of the reverse takeover rules;
  - (b) the bright-line tests in respect of "change in control" (i.e. Listing Rule 14.06(6)(a) and (b)) should not be changed;
  - (c) the definition of "control" in the Listing Rules should not be de-linked from the definition of control in the Takeovers Code;
  - (d) changes in de facto control and the issue of highly dilutive convertible securities should be included as factors for consideration of whether the case is an "extreme case" under the principle-based test; and
  - (e) the 24-month "look back" test<sup>17</sup> should not be changed.
60. In May 2014 the Exchange published a guidance letter<sup>18</sup> on its application of the reverse takeover rules. The guidance, among others, clarified that:
  - (a) in considering whether a very substantial acquisition is a reverse takeover transaction, the Exchange will take into account a basket of factors including the change in "de facto control" resulting from the issue of restricted convertible securities<sup>19</sup>; and
  - (b) a very substantial acquisition which is considered an "extreme" case<sup>20</sup> would be presented to the Listing Committee for decision. Where the Listing Committee

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<sup>16</sup> Report on the Securities and Futures Commission's 2013 annual review of the Exchange's performance in its regulation of listing matters.

<sup>17</sup> This refers to Rule 14.06(b) in which the Exchange will scrutinise acquisitions by its incoming controlling shareholder within 24 months after a change in control when considering whether there is a reverse takeover.

<sup>18</sup> Guidance on application of the reverse takeover requirements under Rule 14.06(6) (GEM Rule 19.06(6)).

<sup>19</sup> Restricted convertible securities are highly dilutive securities with a conversion restriction mechanism (e.g. restriction from conversion that would cause the securities holder to hold 30% interest or more) to avoid triggering a change of control under the Code on Takeovers and Mergers.

<sup>20</sup> The Exchange applies the "extreme case" criteria to determine whether a very substantial acquisition is an "extreme" case. The criteria include: (1) size of the acquisition relative to the size of the company; (2) the quality of the acquired business; (3) the nature and scale of the company's business before the acquisition; (4) any fundamental change in the company's principal business; (5) other events and transactions which together with the acquisition form a series of arrangements to circumvent the reverse takeover rules; and (6) any issue of highly dilutive convertible securities to the vendor which would provide it with de facto control of the issuer.





resolves that the reverse takeover rules do not apply to the acquisition, the Exchange will require the company to apply the standard of disclosure for listing documents for new listing applications in preparing the transaction circular and to appoint a financial adviser to conduct due diligence on the acquisition. The financial adviser will be subject to similar standards of work as a sponsor.

61. Whether the policy concerns in relation to backdoor listings and reverse takeovers are adequately addressed by the May 2014 guidance letter is a separate issue to be considered.
62. For the purpose of this year's review, we reviewed the Exchange's operational processes and procedures in processing reverse takeover transactions to ensure that it has followed the procedures as set out in its guidance letter issued in May 2014 in considering very substantial acquisition transactions. Our review covered transactions processed by the Exchange after the release of the guidance. We also reviewed the Exchange's case files on a sample of these transactions.
63. The Exchange followed its guidance in vetting reverse takeover transactions. We note that the Exchange has taken into account the list of criteria set out in the guidance (including the change in "de facto control" resulting from the issue of restricted convertible securities) in determining whether a very substantial acquisition is an extreme case. The Exchange has sought the Listing Committee's endorsement of the Listing Department's decision on extreme cases.

#### **Liquidity provision performance of structured products issuers**

64. In July 2012 the Exchange published a "Guide on enhancing regulation of the listed structured products market" (Guide). The Guide aims to foster high standards across structured products issuers, enhance service levels of liquidity providers and promote the healthy long-term development of Hong Kong's listed structured products market.
65. The Guide covers a number of regulatory enhancement measures including improvement of liquidity provision services levels. The Guide introduced new active quote standards as industry best practices and tightened liquidity obligations for quote requests. The Guide clarified that issuers should comply with the industry best practices. While issuers should comply with the practices, they are not intended to be binding commitments nor should they give rise to enforceable obligations or duties. However compliance with the industry best practices is relevant to the Exchange's assessment of an issuer's suitability to list structured products.
66. Under the new active quote standards, issuers are expected to provide quotes for products with an active underlying under certain market conditions for at least 90% of the time of a trading day and that each pause will not exceed 10 minutes. Depending on the product category, the maximum bid-ask spreads are between 5 and 15 spreads<sup>21</sup>.
67. Under the Guide, liquidity provision for quote request was also tightened as follows:
  - (a) maximum response time was reduced from 15 minutes to 10 minutes;
  - (b) maximum bid-offer spread was reduced from 25 spreads to 20 spreads;

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<sup>21</sup> (i) 5 spreads for warrants with local index underlying; (ii) 10 spreads for warrants with an actively traded stock underlying or CBBCs with local index underlying; (iii) 15 spreads for CBBCs with an actively traded stock underlying.



- (c) a five minute minimum holding time for quotes was introduced; and
  - (d) minimum quote size was increased from 10 board lots to 20 board lots.
68. Together with the introduction of new standards for active quotes, a mechanism was implemented to allow the Exchange to monitor issuers' liquidity performance to identify if any enhancements are needed.
69. The Exchange monitors issuers' liquidity provision performance on a regular basis by reference to its internally generated reports. Responsible officers at the Exchange follow up with the relevant issuers on all identified cases of potential non-compliance. Active quote performance is monitored on a daily basis while quote request performance is monitored on a monthly basis. In addition, monthly reports which summarised all non-compliance cases in respect of active quotes and quote requests are reviewed by and discussed with the team head.
70. We reviewed the Exchange's processes and procedures for monitoring issuers' liquidity performance. We also reviewed all of the Exchange's monthly monitoring reports in respect of active quotes and quote requests in 2014.
71. We noted that two issuers repeatedly failed to meet the expected service standards for active quotes. As advised by the Exchange, a majority of the non-compliance was caused by the need for more time to adjust or re-confirm quotes, human errors or oversight of traders.
- (a) In 2014, one issuer failed to meet the service standards for active quotes in 139 cases out of a total of 14,954 cases, representing a failure rate of 0.93%. These failures occurred throughout that year. In all of these cases the Exchange dealt with the non-compliance by way of verbal guidance notwithstanding that the issuer had repeatedly failed to meet the expected standards for active quotes.
  - (b) Another issuer failed to meet the service standards for active quotes in 62 cases out of a total of 53,860 cases, representing a failure rate of 0.12%. These failures occurred in 9 months in 2014. For most of these cases of non-compliance, verbal guidance was given by the Exchange. Written guidance was given in respect of 11 non-compliance cases which were caused mainly by the issuer's errors in setting the active quote criteria. For cases caused by system deficiencies, the Exchange had followed up with the issuer which had subsequently rectified such deficiencies.
72. The Exchange explained that as the provision of active quotes is a best practice and not a committed obligation, it generally gives verbal guidance to remind issuers of the active quote requirements and follow-up with issuers to rectify system deficiencies to prevent future recurrence.
73. As discussed in paragraph 65, issuers should comply with the service standards for active quotes. Failure to comply with these standards might affect an issuer's suitability to list structured products. Whilst we note that the non-compliance rate for these issuers is not significant, the issue of repeated non-compliance should not be tolerated.
74. The actions taken by the Exchange should commensurate with the seriousness and frequency of the issuers' non-compliance. In light of the above, we recommend that the Exchange should consider taking more severe regulatory action to address repeated non-compliance with the active quote requirements under the Guide. In this regard, we note





that in August 2015, the Exchange has started a periodic review of the performance of structured products issuers and liquidity providers, in addition to its daily monitoring. The purpose of the review is to identify repeated occurrence of non-compliances over a period of time. Based on the review, the Exchange has issued reminder letters to relevant issuers.

## **Recommendations**

75. We set out below our recommendations discussed above:

- (a) as regards guidance relating to the Listing Rules, the Exchange reviews the process for determining when post-listing matters, such as waiver applications, rule interpretations or decisions should be escalated to the Listing Committee for its consideration and endorsement. Relevant information and the rationale for decisions should be clearly set out in published guidance materials to facilitate the public's understanding of the issues; and
- (b) as regards liquidity performance of structured product issuers, the Exchange should adopt a more stringent approach towards repeated non-compliance of the active quote requirements under the Guide. We note that in August 2015, the Exchange has started a periodic review of the performance of structured products issuers and liquidity providers, in addition to its daily monitoring. The purpose of the review is to identify repeated occurrence of non-compliances over a period of time. Based on the review, the Exchange has issued reminder letters to relevant issuers.



## Appendix A

Set out below is a profile of respondents to our survey on the Exchange's performance over the last five years.

	2011	2012	2013	2014	2015
Professional advisers	17	16	14	21	20
<i>Investment bankers</i>	7	5	4	8	7
<i>Legal advisers</i>	4	5	4	5	5
<i>Accountants</i>	6	6	6	8	8
Investors	15	21	15	20	9
Listed companies	19	15	17	13	11
Listing Committee members	10	13	11	18	16
<b>Total responses</b>	<b>61</b>	<b>65</b>	<b>57</b>	<b>72</b>	<b>56</b>
<b>Number of questionnaires sent</b>	<b>184</b>	<b>189</b>	<b>188</b>	<b>179</b>	<b>162</b>
<b>Response rate</b>	<b>33.1%</b>	<b>34.4%</b>	<b>30.3%</b>	<b>40.2%</b>	<b>34.6%</b>

The table below sets out the weighted average scores given by the survey respondents. 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.

		2011	2012	2013	2014	2015
<b>Views on the Exchange's performance in its regulation of listing related matters</b>						
1.	Communications to the market of the Exchange's policies and practices under the Listing Rules as regards their clarity, adequacy and timeliness	3.8	3.9	4.0	4.1	4.1
2.	Timely response to the market developments	3.5	3.6	3.7	3.7	3.8
3.	Acting in the interests of the investing public	3.9	3.8	3.9	4.1	4.0
4.	Provision of a fair, orderly and efficient market for the trading of the securities	4.0	4.0	4.0	4.0	4.1
5.	Success in ensuring that the disclosure of price sensitive information made by listed companies is on a timely basis	3.7	3.7	3.8 <sup>22</sup>	3.9	4.0
6.	Equal and fair treatment of all holders of listed companies	3.8	3.7	3.7	3.8	4.0
7.	Quality of companies listed	3.3	3.4	3.3	3.5	3.5

<sup>22</sup> The Disclosure of Inside Information regime under Part XIVA of the SFO came into effect on 1 January 2013.



		2011	2012	2013	2014	2015
<b>Views on the Listing Department's performance</b>						
8.	Consistency in interpretation and application of the Listing Rules	3.8	4.1	3.9	4.1	4.2
9.	Impartiality	4.0	4.2	4.1	4.3	4.3
10.	Timeliness of responses	4.1	4.1	4.0	4.3	4.3
11.	Pertinence of enquiries and comments raised during the vetting process or investigation process	3.9	4.0	3.9	4.0	4.1
12.	Experience and knowledge of the Listing Rules as regards its understanding of the policy issues behind the Listing Rules	4.0	3.9	4.1	4.2	4.3
13.	Experience and knowledge of the Listing Rules as regards its understanding of the requirements of the relevant provisions in the Listing Rules	4.2	4.3	4.2	4.3	4.4
<b>Views on the various aspects of the IPO and C&amp;M Teams' work</b>						
14.	Handling general enquiries	4.1	4.1	4.0	4.2	4.1
15.	Handling requests for guidance on the application of a particular Listing Rule	4.0	4.0	3.9	4.1	4.1
16.	Processing applications for waivers	3.8	4.0	4.0	4.1	4.1
17.	Processing listing applications	4.0	4.1	3.9	4.3	4.2
18.	Clearing draft announcements, circulars and other corporate information	4.1	4.1	4.1	4.3	4.2
19.	Handling complaints	3.5	3.7	3.9	4.0	3.8
20.	Handling short term suspension	3.9	3.9	3.6	4.3	4.0
21.	Handling long term suspension	3.5	3.7	3.5	4.0	3.8
22.	Handling of pre-IPO enquiries	4.0	3.9	3.7	4.1	4.0



		2011	2012	2013	2014	2015
<b>Views on the quality of disclosure documents vetted by the Exchange</b>						
23.	Clarity of prospectuses, announcements, circulars and other corporate information	3.6	3.7	3.7	3.9	4.0
24.	Adequacy of information in these documents to enable investors and shareholders (where relevant) to make properly informed assessment of the relevant issuer	3.8	3.8	3.8	4.0	3.9
25.	Ease of understanding of these documents	3.5	3.4	3.5	3.7	3.7
26.	Timeliness of issue of announcements and circulars	3.9	3.8	3.8	4.0	4.0
<b>Views on the Exchange's performance in monitoring compliance with and enforcement of the Listing Rules</b>						
27.	Success in monitoring compliance with the Listing Rules by listed companies and directors	3.7	3.8	3.9	4.1	4.0
28.	Timeliness of disciplinary action taken against listed companies and directors	3.3	3.3	3.3	3.6	3.5
29.	Transparency of policy on disciplinary actions	3.4	3.7	3.4	4.0	3.9
30.	Consistency in approach taken in disciplinary cases	3.8	3.6	3.3	3.9	4.0
<b>Views on the Exchange's performance in conducting consultations</b>						
31.	Comprehensibility of the issues and proposals in the consultation papers	3.9	3.9	4.0	4.1	4.1
32.	Adequacy of the consultation period to consider and respond to the consultation papers	3.9	3.8	3.8	4.0	4.0
33.	Adequacy of guidance and measures to facilitate transition to amended rules	3.7	3.7	3.8	3.9	3.9
34.	Adequacy of publicity to raise awareness of new or amended rules	3.7	3.6	3.7	3.7	3.7
35.	Adequacy of explanation and discussion of the issues raised, the arguments and the proposals in the consultation papers	3.6	3.6	3.7	3.8	3.8
<b>Overall average scores</b>		3.8	3.8	3.8	4.0	4.0