"Combined Consultation Paper on Proposed Changes to the Listing Rules"
Hong Kong Exchanges and Clearing Ltd (HKEx)
January 2008

Summary of issues and ACGA comments

1. **Use of websites for communication with shareholders**: This proposal encourages the greater use of websites for the electronic distribution of company reports and other communications. In a nutshell, it makes it easier for companies to seek the blanket agreement of their shareholders for such electronic distribution (while still allowing individual shareholders to "opt out" and ask for hard copies, if they wish).

ACGA view: This rule change seems sensible and we basically support it. There are some odd features to it, however, including:

- Listed companies incorporated in Hong Kong would not benefit from this rule change until the Companies Ordinance is changed (since the company law requires companies to seek the positive consent of each shareholder before electronic communications can be sent to him/her). It is not clear when the CO will be amended on this point. In the meantime, listed companies incorporated outside Hong Kong—the majority of issuers—will benefit from the rule change.

- While we support the greater use of company websites, the fact is that all listed issuers must send copies of all their corporate communications to HKEx for inclusion in its website—and HKEx archives these materials for much longer than most listed companies and organises them more logically. It is much easier, therefore, to use the HKEx website to access these documents than to go to different company websites. This suggests that the purpose of the rule is more one of cost-cutting for companies than genuinely improving the websites of listed companies.

2. **Information gathering powers:** The Exchange often finds it difficult to get information from listed companies, especially when the latter are subject to disciplinary hearings. Directors sometimes refuse to reply or to accept a notice of a hearing, which in some cases has caused significant delays. The aim of this rule change is to clarify the obligations of issuers and directors in such circumstances and firm up the Exchange's powers.

ACGA view: We strongly support this, having witnessed first-hand in the Listing Committee how uncooperative some companies can be.

3. **Qualified accountants:** The Exchange proposes removing a requirement that each listed company have a "qualified accountant" in their senior management team (ie, someone who is a member of the Hong Kong Institute of CPAs or a similar body recognized by HKICPA). This catalyst for this rule change is pressure from PRC issuers who have complained that it is costly, impractical and discriminates against accountants with different accounting qualifications (ie, accountants from China). HKEx argues that the change should be acceptable

since China is now adopting IFRS, while Hong Kong has a new regulator to oversee financial reporting standards, called the Financial Reporting Council.

ACGA view: We oppose this proposal, which sends the wrong signal to the market and which will almost certainly lead to a decline in financial reporting standards. While the current rule may be somewhat restrictive, the new proposal sets no qualification requirement. Instead, it allows issuers to decide who their accountant will be and whether they need to have any qualification. Given the international nature of the Hong Kong market, it would seem more sensible for the Exchange to require all listed companies to have at least one accountant with an internationally recognised qualification. If PRC issuers cannot find such a person, then they should not list in Hong Kong. Their arguments against the rule are unconvincing.

4. **Sponsor's independence:** This is a fairly simple rule change designed to ensure that an investment bank sponsoring a listing is independent throughout the entire process. A loophole in the current rule could allow a sponsor that is not independent during most of the process, but which becomes independent at the end, to still declare itself to be independent.

ACGA view: This seems to be a sensible rule change.

5. **Minimum public float:** The Exchange proposes allowing more flexibility in the way the public float is set, so that companies with very large market capitalizations can have a smaller percentage float. To some degree this is already allowed: while most issuers are required to have a minimum public float of 25%, the level can fall to 15% if their market cap at the time of listing is more than HK$10 billion (US$1.28 billion). The proposal now is to allow companies with a market cap of more than HK$40 billion to have a public float of 10%. The rationale is that even with the lower percentage there should still be sufficient shares in public hands for a fair and orderly market (since 10% of $40 billion is much higher than 15% of $10 billion). The main catalyst for this rule change is large PRC listing applicants who often claim that they cannot sell more than 10% of their shares to the public (for various regulatory or other government-related reasons). Instead, they seek a waiver to allow strategic investors holding 5% or more of their shares to be included in their "public" float, thus technically meeting the current 15% rule.

   The proposed rule change also sets some minimum values in dollar terms for securities held in public hands, however, so as to avoid certain anomalous situations occurring. Issuers with a market cap of more than HK$10 billion, but not exceeding HK$40 billion, must have a public float with a market value of at least $2.5 billion (or 15% of their shares, whichever is higher). This is because a situation could arise whereby a company with a market cap of just under $10 billion would have to have a public float worth slightly less than $2.5 billion (ie, 25% of its market cap), whereas a company with a market cap of slightly more than $10 billion could get away with a public float worth only $1.5 billion (based on the lower 15% level).

   Following the same logic, issuers with market caps of more than $40 billion must have a public float with a market value of at least $6 billion (or 10% of their total issued shares, whichever is higher). This is to ensure that the value of their

public float is not lower than the level that would be required for companies with a market cap of just under $40 billion (ie, 15% of just under $40 billion is almost $6 billion).

ACGA view: Our general position is that public floats should be larger, not smaller, since this contributes to stronger market discipline and improved corporate governance over time. The Exchange's proposal in this instance has some merit, however. The main issue it seeks to address is the practice, mentioned above, whereby the Exchange often gives (or feels it is forced to give) very large issuers from China a waiver on strict compliance with the 15% rule and allows them to count strategic investors in their public float. Since these investors typically have lock-up periods of six months to three years, seats on the board, and other strategic business agreements, it makes a mockery of the public float rule to pretend they are "public". The proposed rule change, while not ideal, would bring greater clarity to this area and would, we hope, set a rule that could not be waived. In substance, therefore, the rule change basically codifies current Exchange practice—so nothing substantive is really changing for investors.

One concern we have is whether or not the rule change would encourage large PRC issuers in future to seek waivers to include strategic investors in their 10% public float. This would be a retrograde step. The Exchange is also proposing to tighten the definition of "public" so that it does not include investors holding 5% or more of the voting power in the company, and it is further proposing that any shares subject to a lock-up of more than six months should not be counted as part of the public float. While these proposals move in the right direction, we are not sure if they go far enough. For example, companies could invite strategic or major financial investors to structure their investments so as to avoid these rules (ie, voting power of 4.9%; no formal lock-up period, but an informal agreement not to sell, etc). I think such a scenario is almost inevitable, since in the Listing Committee of HKEx we are seeing quite a few companies structuring deals to avoid breaching Listing Rules (eg, M&A deals structured so that new investors do not breach the 30% ownership level, which would trigger a general offer or Exchange concerns about a reverse takeover or change in control).

6. **Bonus issues of a class of securities new to listing:** We do not have a view on this item.

7. **Pre-vetting of issuer documents:** In recent years, the Exchange has been trying to do less vetting and checking of issuer documents (reports, announcements, notices, circulars, etc) before they are released to the market. It now proposes to up the ante a notch by ceasing the pre-vetting of all "announcements". It will do this in two phases: first, stopping the pre-vetting of all announcements immediately after a rule change, except for those relating to transactions that require shareholder approval or to connected transactions; second, ceasing the pre-vetting of all announcements within one year after the rule change.

   The Exchange also proposes to reduce its pre-vetting of "circulars" (which are usually considerably longer and more detailed than announcements). It will focus mostly on circulars relating to significant transactions or matters that pose a

higher compliance risk, while ceasing the vetting of circulars covering routine matters (eg, amendments to Articles or descriptions of share buybacks).

The Exchange also says that these changes will allow it to shift more of its regulatory focus from pre-vetting to post-vetting, monitoring and enforcement.

ACGA view: We strongly support this change in principle, since the Exchange spends far too much time on pre-vetting issuer documents and doing work that companies and/or their advisors should be doing. Shifting more attention to post-vetting and enforcement makes sense. However, it is likely that this change will lead to a short-term decline in the quality of information released to the market, since it will take issuers time to adapt to the new system (many of them are known for producing poorly written documents).

We would also like more information from the Exchange on what this change will mean for its internal resources, specifically whether it will shift staff from its compliance/monitoring division to its enforcement division. Presumably it will, but the consultation document does not touch upon this. More significantly, the change will no doubt result in an increase in disciplinary hearings for breaches of the Listing Rules. We would like to know how the Exchange plans to make the disciplinary process more efficient, since most cases today proceed through the enforcement system at a strikingly slow pace.

8. **Disclosure of changes in issued share capital:** The proposal here is to ensure that the market is more quickly and completely informed of changes in an issuer's share capital. The Listing Rules require companies to make announcements whenever they issue securities as part of a "share transaction" or a private placement under the 20% general mandate. But otherwise, companies are under no obligation to publish announcements every time they issue shares or when there are other changes in their issued share capital.

   The Exchange is proposing that there should now be "next-day disclosure" (by 9am on the morning of the next business day) of any changes in issued share capital resulting from a range of transactions, including: placings, open offers, rights issues, bonus issues, exercise of options by directors, and so on (see p48-9 for a full list). For some types of transaction, such as the conversion of convertible securities, next-day disclosure will only be required if certain minimum thresholds are reached (eg, issued share capital changes by 5% or more).

   The Exchange will also make it mandatory for issuers to submit a "monthly return" on movements in its share capital (to date this has only been a request made of listed companies).

   And there will be a new requirement that issuers disclose "as soon as possible" the grant of any new stock options under a share-option scheme.

ACGA view: Most of these changes are sensible and long overdue. We need to study the minimum-threshold issue a little more, to see if there are any potential problems or unintended consequences, and also the new rule on share-option disclosure. But otherwise it is a good rule change.

9. **Announcements re issues of securities for cash and allocation of excess shares in rights issues.** We will come back to you on this. But from a quick reading, it seems like a sensible rule change.

10. **Material dilution in a major subsidiary:** We have no views on this.

11. **General mandates:** The Exchange is not proposing a rule change at this stage, but wants to "facilitate public discussion" on this issue. As many ACGA members will know, this issue relates to the rule allowing companies to issue new shares on a private placement basis (ie, non-preemptively) up to 20% of their issued capital and up to a 20% discount. Any repurchased shares—up to 10% of issued capital—can be added to the 20% mandate. Investors have been voting against this rule in large numbers in recent years and have been asking companies to voluntarily cut their mandates to 5% or 10% (and discounts too). Some leading companies have done so, but most issuers in Hong Kong continue to resist any change—and vociferously argue against any rule change. The Exchange has clearly put this issue into the "too hard" basket and has so far avoided doing anything on a regulatory level (although as a listed company, HKEx has eliminated its own mandate!).

ACGA view: We consider that the UK guidelines on this issue are reasonable and this would be our preferred position for Hong Kong (ie, a 5% mandate and no more than a 5% discount; although we are less sure whether the cumulative 7.5% rule over three years should be applied to HK/Asia). As a short-term transition measure, however, we do see some merit in accepting a 10% mandate and no more than a 10% discount, if only to start the process of moving the Listing Rules in the right direction and bringing more discipline into this area. Such an outcome would be less than optimal, but better than nothing (and there is a danger that the Exchange will continue to sit on the fence).

One suggestion we will make to the Exchange is that it forms a group similar to the UK's original "pre-emption guidelines group" to debate this issue and come up with a standard that is acceptable to both investors and issuers. This is easier said that done and the Exchange is likely to have little enthusiasm for a real public debate. But it would be worth a try.

Another suggestion we will make is that the Exchange changes the Listing Rules to allow only independent shareholders to vote on the general mandate at each AGM. Since it is the independent shareholders who are being diluted, it seems only fair to give them the sole vote. This would force issuers to justify their arguments for a certain size of mandate, explain what the proceeds will be used for, and explain how they have used such mandates in the past. Such a vote would become even more important if the Exchange chooses not to change the 20% levels (though we hesitate to suggest this as a trade-off).

12. **Voting at general meetings:** The Exchange is seeking market input on whether voting by poll should be made mandatory for annual meetings (or whether companies should only be required to publish the proxy voting results for their AGMs). It is also asking whether the deadline for the release of AGM notices and circulars should be extended to 28 calendar days (from the current 21-day requirement).

ACGA view: Most members would know our views on this one! We believe that all listed companies should vote by poll and should release their AGM notices/circulars 28 days before. While we see some merit in encouraging companies to do this voluntarily—it allows the better governed companies to differentiate themselves from their competitors—the larger argument is that such practices are good for the market as a whole and will produce much improved transparency and accountability in relation to shareholder meetings/voting.

While voting by poll may not be mandatory in the UK or Australia, we believe that both markets are different in some important respects from Hong Kong. The institutional investor community in both is more established, more engaged in corporate governance issues, and enjoys a higher quality dialogue with listed issuers on governance issues. Hence, there is arguably a higher degree of trust between investors and listed companies than in Hong Kong.

At the same time, the arguments against mandatory voting by poll—cost and time—are weak. We have yet to find a company in Hong Kong who has said they find it difficult or expensive. Of the 170 large listed companies in Hong Kong (with market caps of HK$10 billion or above), we found that around 70% voted by poll for all resolutions at their 2007 AGMs. Moreover, companies in Hong Kong must already vote by poll for certain types of transactions that require independent shareholder approval in EGMs (eg, major acquisitions, connected transactions, privatisations). Hence, many will have some experience of voting by poll. To vote by poll at their AGMs, therefore, is an incremental step, not a huge leap. For all these reasons, we think that the benefits of mandatory voting by poll outweigh any costs.

We take a similar view on the 28-day deadline for release of AGM notices and circulars. Most AGM resolutions are routine and it is hard to see why companies could not finalise their agendas and detailed circulars seven days earlier than the rules currently require. Indeed, many companies already exceed the 28-day standard.

13. **Disclosure of information about directors:** The Exchange proposes a rule change to require biographical details about directors to be disclosed continuously, not just upon appointment, re-designation or resignation. It also proposes expanding the scope of the biographical information disclosed to include directorships in listed companies outside Hong Kong (for the previous three years).

ACGA view: These rule changes are sensible. Our only comment is that directors should be required to disclose directorships on the boards of non-profit, charitable or professional organisations in Hong Kong or elsewhere, since these roles can be time-consuming as well.

14. **Codification of waiver to property companies:** We have no views on this.

15. **Self-constructed fixed assets:** No views on this either.

16. **Disclosure of information in takeovers:** The Exchange proposes to codify its current practice to grant waivers if an offeror cannot get access to non-public information of an offeree (as is sometimes the case in transactions involving companies in China or subsidiaries of state enterprises or hostile takeovers). In such cases, the Exchange will require the offeror to disclose any material information at a later date, once the takeover has been completed.

ACGA view: This seems to be a pragmatic proposal and will add certainty to what has to be disclosed before a takeover bid. However, we want to talk with market participants before coming to a final conclusion.

17. **Review of director's and supervisor's declaration and undertaking:** This section of the paper contains several proposals. First, the Exchange proposes streamlining the "declaration and undertaking" forms that each new director or supervisor must sign, so as to avoid duplication as regards disclosure of biographical information (see Issue 13 above) and to simplify procedures relating to a statutory declaration that directors must make regarding bankruptcy, litigation and convictions (if any). Second, a new rule would be introduced giving the Exchange "express general powers to gather information from directors". This mimics the proposal in Issue 2 above. Third, a rule change to require directors of Mainboard companies to give the same undertaking as currently required of GEM companies, that is a director must agree to keep the Exchange informed of his/her residential address and for three years after ceasing to hold that position. This is to ensure that the Exchange can serve disciplinary or other notices on directors. (Note: Resignation or retirement from a board does not remove any liability a director may have for rule breaches during their term of office.)

ACGA view: Most of these proposals seem sensible. However, we need to look a little more into the issue of streamlining the director's statutory declaration. The change seems somewhat weaker than current requirements.

18. **Model Code for securities transactions by directors:** The main proposal here relates to the "black out" period governing when directors are prohibited from dealing in the securities of their listed companies (so as to minimise the risk or suspicion of insider trading). The current black-out period essentially starts one month before the date of a results announcement (for both annual and interim results) and ends on the date of the announcement. The Exchange proposes to extend this to the entire period between a company's year-end and the date of its results announcement.

ACGA view: We support this proposal. Given that issuers in Hong Kong have up to four months to report their annual results—and many utilise the full period—the current black-out rules mean that directors can trade on inside information during months one to three after their year-end, and must only stop trading in month four. This rule should encourage companies to release their results much more quickly—which is another major area of weakness in Hong Kong corporate governance.