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Demutualization of Exchanges— The Conflicts of Interest (Hong Kong)

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5.1 Structure of Exchanges

5.1.1 Mutuels and Share Companies

The legal forms that traditional exchanges have commonly adopted is that of a company limited by guarantee or company limited by shares. Even in those cases where the legal form of an exchange is that of a company limited by shares, the essential character of the organization and operation of the exchange typically resembles that of a cooperative or mutual enterprise.

The distinguishing feature of a mutually-owned exchange is its cooperative structure of governance. The owners of the enterprise, its decision-makers and the direct users of its trading services are the same persons: the member broking firms. Decisions are usually made on a one-member, one-vote basis, and often are made by committees representing the interests of member firms. In a true mutual, ownership rights are not freely transferable and may terminate with cessation of membership. Where a shareholding structure is used, the company is typically nonpublic and share ownership is confined to a small group, usually brokers. Often, a number of independent or public representatives are appointed to the board to offset the self interest of the members.

Within these traditional structures, the exchange is expected to perform regulatory functions such as listing and prudential and conduct

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regulation of its broker members. The exchange is in turn regulated or overseen by a statutory regulator or an arm of government.

In contrast, most for-profit enterprises are organized as corporations with share capital under which the owners of the company, its decision-makers and its principal customers may well be three separate groups. The shareholders vest decision-making power for the company in a board of directors who are subject to election and removal by shareholders. Day-to-day decisions are made by the management of the corporation. The voting rights of shareholders are generally commensurate with their economic interest in the company: one share, one vote. Companies limited by shares may raise new capital in a variety of ways and from various sources.²

5.1.2 Demutualization of Exchanges

In recent years there has been a trend for exchanges to convert from not-for-profit member-owned organizations into for-profit shareholder-owned organizations. This process has become known as “demutualization” without strict regard to whether prior to conversion the exchange was truly “mutual” or “cooperative” in nature, or a company limited by shares. The restructuring involves moving from an entity in which ownership of a share or “seat” in the exchange confers a right to trade on, and have some influence over the management of, the exchange, into an entity where ownership rights and trading rights are separate, and where the right to trade confers no ownership or management right.

The trend to demutualize is being driven largely by changes in technology and increased competition. Trading technology is developing rapidly and is expensive to install and maintain. Competition from electronic communication networks (ECNs) and other alternative trading systems offering anonymity and alternative or lower cost structures is drawing volume away from traditional exchanges. These developments are forcing traditional exchanges to become more efficient in all activities, including in their decision-making processes.

The conventional rationale for public companies limited by shares is profit maximization. It has been said that the single overriding objective shared by all listed public companies, whatever their size or type of business, is the preservation and the greatest practicable enhancement over time of their shareholders’ investment. A public company is able,

² Part 5.1 is based on an extract from the Issues Paper on Stock Exchange Demutualization prepared by the IOSCO Technical Committee, June 2001.

and under some pressure, to distribute profits to its owners. For-profit enterprises are said to respond to a changing environment quickly, and engender a proprietorial sense in shareholders and holders of stock options (e.g. management).

Public companies are disciplined by competition from other companies and it is this competition which forces the creation of mechanisms to efficiently monitor the performance of management. Ownership is seen as a key factor in determining the ability of a company to respond to market and regulatory developments. Under a mutual governance structure the exchange is focused primarily on how its operations affect the personal or business interests of each member stockbroker. External ownership of a public company enables it to focus on the requirements of the exchange as a business and increase its capacity to make the difficult business decisions required by changing markets, technology and international and domestic competition.

Demutualization is seen as facilitating a response to market and regulatory developments by:

- (i) separating rights of ownership from rights to trade and rights to manage;
- (ii) removing certain inefficiencies and conflicts of interest which impaired the decision-making process; and
- (iii) facilitating capital raising and alliances or mergers between exchanges.

The decision to demutualize has far-reaching consequences both for the exchange and the traditional manner of its operation, and for the regulatory framework for securities and futures markets.

5.1.3 Multiple Roles of an Exchange

An exchange, demutualized or not, has a number of roles. On the one hand, it is a commercial entity carrying on the business of running an exchange and seeking to protect and promote its business. On the other hand, it plays a critical role in ensuring the integrity and efficiency of capital markets by setting and enforcing rules to regulate its market.

The commercial role of an exchange is to provide services and generate revenues. Exchanges generate revenues from listings, trading services, settlement fees, market data fees, and membership fees. This

revenue is derived directly from those who use or purchase services or information from the exchange: the brokers, intermediaries, listed issuers and information vendors, and indirectly from the investing public.

In performing their role in the capital markets, exchanges are usually viewed as performing public functions and are subject to oversight by the statutory regulator or government. Many are further vested with self-regulatory functions involving regulation of listed companies and member brokers.

5.2 Regulatory Role and Self-Regulation

The typical self-regulatory functions of exchanges are the regulation of trading and listing on the exchange and the regulation of member brokers. Regulation of trading includes admitting new users to the exchange trading system, devising rules for trading and enforcing them. Regulation of member brokers includes monitoring financial resources and conduct. Regulation of listing includes determining qualifications for listing, approving new applicants and monitoring listed issuers ongoing compliance with the listing rules (including continuous disclosure of material information to the market).

5.2.1 Advantages of Self-Regulation

Proponents assert that self-regulation offers a number of benefits.

Self-regulation is best suited to monitor conduct, which lies beyond the practical reach of the law. Trading is a fluid activity and rule books need to deal with matters and concepts which do not lend themselves to statutory language and formal principles of statutory interpretation. Furthermore, self-regulatory rules can be more effective because of the self-regulatory organization's (SRO) intimate knowledge of the trading environment and market practices compared to government officials and the judiciary. Exchange management and

regulatory staff are closer to the market activity and likely to be better placed to understand what may be going on.³

Market participants may have a strong interest in maintaining the integrity of the markets on which they trade. They stand to lose most if market misconduct leads to lower turnover and causes a migration of liquidity and trading activity.

Presence of market practitioners as self-regulators enhances knowledge, expertise and experience of regulatory authorities and the relevance of regulation. Also, market practitioners learn about the regulatory process by participating in it and thereby enhancing their firms' internal compliance with their regulatory duties.

Rules imposed by industry peers carry more legitimacy with market participants than those imposed by an external regulator. Self-regulation results in better compliance because self-enforcement is more effective and more readily accepted by the regulated entities. Industry participants bring to the task expertise and intimate knowledge of the complexities of the industry and can respond more quickly to regulatory problems. The rules are likely to be tailored to the conditions of the regulated industry and accepted as being more reasonable compared with prescriptive rules issued by a government agency.

It is more difficult for statutory regulators or governments funded by public revenue to pay the same wages or attract the same calibre of people as private sector regulators funded by the market.

Self-regulation seeks to avoid prescriptive methods of regulation. Prescriptive and legalistic rules limit discretion and are criticized as being largely ineffective particularly when compared with their costs. Also, policies determined by self-regulation may be less susceptible to political influences than those determined by a government regulator.

Self-regulation may result in cost savings for government if supervision of the regulated industry requires fewer resources than direct regulation and less costly regulation overall. It is often more efficient for government to rely on the SRO's knowledge and expertise than try to reproduce it at a governmental level.

³ Under self-regulation, as the U.S. Securities and Exchange Commission (SEC) pointed out in its report on the National Association of Securities Dealers, Inc. (NASD) (see note 4, *infra*), it is not sufficient merely for an SRO to have a knowledge of the regulated activity. It must be prepared to act on its superior knowledge in the public interest: "The benefits of self-regulation, however, can be realized only if, among other things, the SRO fully informs itself of the nature and purposes of the full range of activities occurring in the market. The SRO must vigilantly surveil and investigate the activities of market participants and take appropriate action as warranted under the facts and as required by law."

Finally, self-regulatory organizations are able to modify their rules quickly in response to developments in the business environment. The bureaucratic structures of government agencies and rigid, formal requirements for rule making and enforcement inhibit innovation and quick responses to sudden changes in the environment. Under the pressure of competition, SROs have a strong incentive to keep their rules current and cost effective.

5.2.2 Disadvantages of Self-Regulation

The following reasons are seen as being disadvantages of self-regulation.

Self-regulatory organizations do not have adequate statutory enforcement powers—which may be reserved to the statutory regulator—and therefore lose some credibility in exercising enforcement powers. They may be ineffective altogether for cross-border activities.

Self-regulatory organizations have to serve the interests of various constituencies (members, customers and the general public) and reconciling their often conflicting interests can be difficult and lead to inefficiency. Furthermore, the composition of the membership itself, and their role in the governance of the exchange may give particular constituencies undue influence over critical aspects of the exchange operations, such as oversight of trading and enforcement of rules and regulations, and lead to deficiencies in the performance of these functions.

Self-regulatory organizations are often in a monopoly position and may seek to preserve and enhance that position to the detriment of members, customers and the general public. Alternatively, as membership organisations they may regulate the market they operate to their own advantage and contrary to the public interest. An SRO may use its regulatory power to impose purely anti-competitive restraints as opposed to those justified by regulatory needs. Similarly, the SRO may resist change in the regulatory pattern because of vested economic interests in its preservation or insufficient knowledge of newly developing market conventions or investor needs.

Self-regulatory organizations may be required to supervise intermediaries who have no interest in the markets the SRO operates (such as investment advisers who are not licensed to trade on the exchange), again resulting in conflicts of interest between those persons and intermediaries who are members of the exchange. This may also give rise to arguments as to the proper apportionment of costs between different classes of intermediaries.

The structure of government regulation plus SRO is duplicative and costly. If there are several SROs with overlapping jurisdictions, their independent licensing, market surveillance and enforcement activities may further duplicate each other and force market participants to incur unnecessary time and costs in complying with different regulatory regimes.

Competition and innovation may be stifled if every exchange SRO is expected to perform the full range of SRO functions. Performance of all functions may be uneconomic and irrelevant for smaller niche markets. However, not to require full SRO functions in every case creates inequality and increases the administrative burden of the statutory regulator in discharging its monitoring and supervisory functions.

The combination of fulfilling self-regulatory and commercial goals splits the SRO focus such that it excels at neither. The potentially conflicting goals also inhibit the SRO ability to raise capital.

5.3 Public Policy Objectives of Stock Market Regulation

The public policy objectives of securities regulation are generally common to most jurisdictions. The Objectives and Principles of Securities Regulation of the International Organization of Securities Commissions (IOSCO) succinctly state these objectives to be the protection of investors, ensuring that markets are fair, efficient and transparent, and the reduction of systemic risk.

Arguably, the underlying objective of stock market regulation is ensuring market integrity such that users will have confidence in using the markets. This means adopting processes that result in markets being transparent, users being treated fairly, the price formation process being reliable and markets being free of misleading, manipulative or abusive conduct.

In the report of its investigation of NASD and the NASDAQ Stock Market (NASDAQ) in 1996, the SEC's view of the standard for a self-regulatory organisation is clearly expressed: "While self-regulation benefits from the knowledge, insight and expertise brought by industry participants it must give primacy to the fundamental purpose of regulation of the securities markets: the protection of investors and the public interest."⁴

⁴ Report pursuant to Section 21(a) of the Securities Act of 1934 regarding the NASD and the NASDAQ Market, Securities and Exchange Commission, CCH, at 88, 292-362 (6 August 1996).

As a regulatory body NASD's most important constituency was the investing public, not listed companies or broker-dealers. The report states that there is a tendency for a regulated industry to influence its regulator to protect the industry's proprietary interests. It must guard against the efforts of any one segment of its membership to assert undue influence over its regulatory functions and processes. The public interest must be the predominant concern. Failure of an exchange to take appropriate action in circumstances where some action is dictated by the facts must constitute a failure by an SRO to meet its statutory obligations and its public interest mandate as an SRO.

The characteristic mode of the regulation of securities and futures markets that has emerged to overcome the weaknesses of self-regulation is a system of co-regulation. Under this system SROs generally assume the role of co-regulator with the government regulatory authority to protect investors and the public interest, promote just and equitable principles of trade and prevent fraud and manipulation. The government regulatory authority oversees the SRO and exercises statutory powers, often including among others its own rule making, powers to compel testimony and production of documents, and sometimes prosecution.

5.4 Why Should Demutualization Require a Reassessment of SRO Functions?

It is recognized that exchanges, which have historically operated as self-regulatory organizations, are subject to conflicts of interest. Conflicts arise because the members are being asked to set rules in the public interest that may negatively affect their own commercial interests and monitor and enforce rules against each other.

A major weakness of self-regulation is the inherent potential for it to favour the interests of the broker members over those of the investing public. Because SROs are left directly in charge of the implementation of a program of government and public policy, and are themselves owned or controlled by the industry participants who are the objects of regulation, self-regulation raises the distinct possibility of inadequate enforcement of rules and standards, and concerted anti-competitive conduct in opposition to the public policy goals. The SRO may, in ways that are not readily apparent to outsiders, subvert the regulatory goals to its own business goals and, by establishing a façade of self-regulation, give the impression of a properly regulated industry.

Demutualization may lessen some of the SRO conflicts. Where demutualization leads to a separation of the owners of an exchange from its users, the interests of the owners may act as a constraint on actions that would benefit the interests of the member firms. The more the shareholder base looks like the public as a whole, the greater this effect is likely to be, as the shareholder interest and the public interest will arguably tend to converge. Furthermore, where a reputation as a fair and efficient market is seen as a competitive advantage (or the lack of one as a significant disadvantage), a for profit exchange may have a greater incentive to devote more resources to activities that enhance that reputation.

More commonly expressed is the concern that a demutualized exchange experiences greater conflicts of interest. Becoming a listed company permits the raising of capital from the public, but brings with it enhanced duties and obligations enshrined in the *Company Law* and listing rules and greater responsibilities to shareholders. These influences combine to accentuate the competitive and profit-making motive. The risk is that a fair and orderly market can remain a goal only if it can pass a commercial cost/benefit analysis. These possibilities are arguably greater still where the SRO is a monopoly with little or no domestic competition.

Conflicts of interest are generally created or increased where the for-profit entity also performs regulatory functions. This is especially the case where the regulatory functions are a cost center rather than a profit center. While not all such possible conflicts will be new, demutualization may exacerbate some of them and this warrants re-examination of issues and regulatory responses. It is necessary to consider carefully whether the commercial pressures and corporate structure of a for-profit entity will undermine the commitment of resources and capabilities of the exchange to fulfill its regulatory and public interest responsibilities to an appropriate standard.

It must, however, also be accepted that commercial considerations are proper considerations for an exchange. Self-regulation is an expensive undertaking, which has considerable public benefits and an exchange must be able to fund the costs of this activity.

5.4.1. Regulatory Concerns with Demutualization

Demutualization may raise regulatory concerns in a number of areas.

Cost cutting on regulatory functions affects the ability to properly perform the relevant function. The exchange competes with other operators providing similar services but who may not carry regulatory

functions. These pressures may affect the proper performance of self-regulatory functions, to the detriment of the market and public interest. In the cost versus benefit equation of “good regulation”, the costs are easier to determine than the benefits. It is not difficult to envisage an exchange being confronted with decisions involving a choice between expenditure on regulatory infrastructure (such as market surveillance or enforcing disclosure of price sensitive information) and financial returns to shareholders.

Lowering of standards to increase business and revenue leads to a race to the bottom. Specifically, a for-profit exchange may wish to lower listing standards in order to attract more companies and increase its fee income; or it may be less willing to take enforcement action against users who are a source of revenue for the exchange.

Conversely, the exchange may seek to use its regulatory powers more vigorously to increase its competitive position (that is, a race to the top), or its revenue. This may arguably include a tendency to apply higher standards or take greater enforcement action than before to generate revenue from fines.

There is an increase in possible conflicts of interest, including those arising between:

- (i) The interests of the exchange and the interests of users, which are regulated by it, particularly where the user may be in competition with the exchange business. There is a risk that the exchange will seek to use its regulatory powers against business competitors which are listed companies or trading members in a way which adversely affects the competitors’ business interests. Conversely, the exchange may be tempted to treat more leniently a regulated user, which is a business associate. Competition laws may not adequately address these situations.
- (ii) The interests of the exchange and the public interest. In the context of exchanges listing on their own markets, it is widely acknowledged that the public interest is not well served by allowing the exchange to supervise itself. The exchange is likely to face conflicts of interest in admitting itself to listing, monitoring its on-going compliance with listing rules, monitoring the trading in its securities and taking necessary enforcement action. Also, an exchange which is successful in attracting new listings may find its own market capitalization increasing. The exchange may try to increase the value of its

securities by seeking to be included in one or more index funds on the basis of its market capitalization. This is especially problematic if the exchange creates its own index fund and becomes a constituent member.

- (iii) The interests of the exchange and the interests of board members, which are associated with regulated users. In the past, concerns have arisen from the fact that representatives of market participants or listed issuers are elected to the board of the exchange. There is a risk that these officers take action on behalf of the exchange which serve their own business interests. These conflicts may be greater where the exchange is a profit-making company, which competes with those business interests.
- (iv) The duties of board members who are representatives of the public interest and their duties to shareholders. Public interest board members may find that they face a conflict between actions, which are in the public interest but may not be in the interests of shareholders.

5.5 What Responses are Being Developed to Deal with These Problems?

The regulatory responses to the issues, which arise upon a demutualization have varied from one jurisdiction to another since they depend upon the prevailing legal framework and regulatory philosophy. However, there has been some consistency in dealing with the issues which arise, and the general approach has tended towards retaining the self-regulatory function for the time being and transferring some regulatory functions to the government regulator. While there are no examples where demutualization has led to the removal of all self-regulatory functions, perhaps the United Kingdom is moving closest to doing so.

The regulatory responses can be divided into three headings: first, changes to the governance structure to ensure that the public interest is safeguarded and prevails over commercial interests; second, changes to the corporate structure to ensure that the regulatory function specifically continues to be performed and is adequately resourced; and finally, changes to the regulatory framework to address the conflicts of interest which arise between the exchange upon its listing and between the exchange and persons dealing with it.

5.5.1 Changes to the Governance Structure

The governance structure of an exchange—whether it is a mutual or a for-profit entity—has an important bearing on its regulatory and commercial performance and on its ability to reconcile the competing interests of its managers, owners and the various users and potential users of its services. The structure may affect the delivery of the self-regulatory functions. A failure in this respect may have an adverse impact on the market as a whole and on the capacity of exchanges to deliver the public policy objectives set for them by governments.

Given the additional pressures that arise upon demutualization, the statutory regulator and/or government may provide for one or more of the following rules:

Persons to represent the public interest may be appointed to the board of directors. In some cases, such as in Hong Kong, the government is empowered under legislation to appoint a majority (in Hong Kong, 8 out of 15) of directors. Furthermore, to overcome the potential conflict such directors may face between reconciling the interests of the public and their duties to shareholders, it may be appropriate to provide a statutory remedy.

In Hong Kong, the demutualization legislation imposes an express duty on the exchange to ensure, so far as reasonably practicable, an orderly and fair market in securities or futures contracts traded on or through the exchange. In discharging this obligation it is required to act in the interests of the public, having particular regard to the interests of the investing public. Where these interests conflict with any other interests that the company is required to serve under any other law, the former must prevail. Since this obligation applies to the exchange, all directors (and not only those appointed by government) are placed in the same position. Furthermore, a statutory indemnity has been provided for the exchange and its officers to remove any potential liability they may have as a result of giving priority to the public interest.

Methods to control the abuse of any monopoly position, including the requirement that changes to fees imposed in the exchange capacity as an exchange should be subject to approval. In Hong Kong, the legislation requires that in considering any such increase, the Securities and Futures Commission (SFC) must have regard to the level of competition, if any, in Hong Kong for the matter for which the fee is imposed, and the level of fees imposed by any similar body in or outside Hong Kong for the same or similar matter.

Oversight by a statutory regulator (as in Hong Kong) or a parliamentary committee (as in Australia) may be provided. Australian legislation requires the Australian Stock Exchange (ASX) to file a report each year and to answer questions in relation to its operations.

Share ownership may be limited (with or without scope for a waiver of those limitations by the statutory regulator or government). In Hong Kong, the legislation provides that no person and his associates may exercise or control the exercise of 5% or more of the voting rights in the exchange unless authorized by SFC. Authorisation is likely to be given in the context of share issues for the purpose of entering into alliances. To ensure that any holding company of an exchange does not dispose of some or all of its shareholding to a third party, it may also be appropriate to require that prior regulatory approval be obtained.

Appendix 1 contains Chapters 4 and 5 of *Hong Kong Exchanges and Clearing Limited (HKEx): Reinforcing Hong Kong's Position as a Global Financial Centre*, a policy paper written by the Financial Services Bureau of the Government of Hong Kong Special Administrative Region of the People's Republic of China in July 1999, which outlines the business and regulatory framework proposed for HKEx following demutualization. These chapters describe in more detail some of the checks and balances put in place Hong Kong to address the conflicts of interest, which were seen to arise.

5.5.2 Changes to the Corporate Structure

Changes may be made to the corporate structure of a group to ensure that the regulatory function continues to be properly performed (i.e., is carried out independently from, and is not compromised by, its commercial operations) and is adequately financed.

These actions often involve transferring some or all of the regulatory function to a separate entity,⁵ such as:

- (i) another group company with an independent governance structure and budget (as in the NASDR/NASDAQ and ASX models);
- (ii) another self-regulatory organization (or giving the choice to

⁵ For a detailed analysis of the advantages and disadvantages of a number of options in this area, see *Reinventing Self-Regulation*, White Paper for the Securities Industry Association's Ad Hoc Committee on Regulatory Implications of Demutualization, 4 January 2000.

contract out the performance of the functions to another SRO or retaining it in-house but securing its performance in various ways); or

(iii) the statutory regulator.

In the second case, an assessment must be made of the capacity of the company and its officers to which the functions are transferred to properly perform them. This may require an assessment of various factors, including: whether the applicant has adequate arrangements in place to operate the market and settle and clear trades, supervise the market, protect retail investors (including compensation funds), and has sufficient resources generally to adequately carry on each of these functions.

Even in jurisdictions where the commitment to self-regulation is strong enough to ensure that there is presently no urge to transfer the regulatory functions to the statutory regulator, it is important to ensure that any restructuring is seen to achieve true independence. Unless the public perception is one of genuine independence then the solution is unlikely to last and pressure will mount for a complete transfer of responsibility to the statutory regulator.

Ensuring adequate resourcing of the regulatory function may also involve imposing capital adequacy requirements or requiring the establishment of reserves, much as for financial intermediaries. There is commonly no requirement for an exchange simply to have sufficient financial resources to conduct its regulatory functions in an efficient manner. Arguably such a requirement is desirable. In the NASD case, the SEC was able to direct the expenditure of sufficient resources to particular areas of regulation.

5.5.3 Conflicts of Interest Upon Listing and Over-Regulation of Users

It is now widely accepted that because of the obvious conflicts of interest involved it is not appropriate for a self-regulatory exchange to be responsible for its own listing or supervising its own compliance with the listing rules and the trading in its securities. It is less obvious what should be done with conflicts arising between the exchange and other users of the exchange. However, these may involve treating a business competitor—to give an obvious example, a listed company or broker setting up a new trading or clearing system—more harshly or a business

associate more leniently than would otherwise be the case. In such cases, powers may be needed to step into the shoes of the exchange and discharge the relevant regulatory function.

In Hong Kong, the demutualization legislation provides that whenever the SFC is satisfied that a conflict of interest exists or may arise, or has existed and may be repeated, between the interests of the exchange and the interests of the proper performance of a regulatory function, the SFC may by notice direct the exchange to take steps specified in the notice (including steps in relation to any of its affairs, business and property) for the purposes of remedying the conflict or the matters occasioning the conflict. The exchange may appeal to the Chief Executive in Council but the notice takes effect immediately.⁶

It can be presumed that in such instances of conflict any third party, which feels it is being prejudiced, will make this known to the statutory regulator. However, it can also be assumed that a business associate of the exchange being given a sweet deal by the exchange will not be so quick to announce it. Furthermore, there may be some concern that users of the exchange will be tempted to complain too readily that conflicts of interests arise and that the exchange becomes increasingly unable to exercise its normal regulatory and disciplinary functions.

While responsibility for stepping into the shoes of the self-regulatory organizations and exercising relevant functions may be assumed by the statutory regulator, it would be possible for the regulator to appoint another person to undertake this function on its behalf.

5.6 Conclusion

A number of new regulatory issues arise when a stock exchange demutualizes. Among other things, it is necessary to review the self-regulatory functions, which are performed. There are good reasons for exchanges to continue as SROs, but some changes will usually need to be made to the corporate and governance structure of the organization to ensure that the self-regulatory function continues to be properly performed and that the public interest is safeguarded.

While self-regulation is firmly accepted as a primary mechanism for the regulation of the securities industry, it needs to be recognized that

⁶ Section 14, Exchanges and Clearing Houses (Merger) Ordinance (Cap. 555).

it also poses risks for the implementation of public policy objectives in the industry: the risk of uneven enforcement, capture of the regulators by the regulated industry and the creation of barriers to entry or competition.

These concerns are not necessarily resolved where a demutualized exchange decides that it is no longer willing to continue to perform all or some of the SRO functions. If nobody is qualified to assume the functions in its place, the government may have to refuse such a transfer. This would no doubt call into question the exchange's commitment to perform the functions to the same standard as before.

The demutualization of an exchange is not incompatible with self-regulation. The ability of the exchange to meet the standards set for it and deliver key regulatory and public interest objectives depends on a range of factors including the overall regulatory framework, the exchange's obligations under the law, the formulation, administration and enforcement of its listing and trading rules, its formal and informal arrangements with the statutory regulator, its management structure, the transparency of its decision making processes, its allocation of resources for particular regulatory functions and the experience and quality of its staff.

Arguably, the capacity and the willingness of the statutory regulator to perform its supervisory role is key to the success of the regulatory framework.

5.7 Hong Kong's Framework: Listing of HKEx and the Framework for Dealing with Conflicts of Interest

Section 13 of the *Exchanges and Clearing Houses (Merger) Ordinance* sets out the framework for HKEx to become a listed company. The section requires that prior to listing rules and arrangements be put in place to deal with possible conflicts of interest which might arise if HKEx were to be a listed company and to adequately ensure the integrity of the securities and futures markets.

The requirements of Section 13 of the *Merger Ordinance* were satisfied by drafting a new *Chapter 38* of the Stock Exchange of Hong Kong Limited's (SEHK's) listing rules and a new Memorandum of Understanding between the SFC, HKEx and SEHK (the Pre-listing MOU). The current version of Pre-listing MOU—which includes, in appendices, Section 13 of the *Merger Ordinance and Chapter 38*—is set out in full in Appendices 2, 3 and 4 of this chapter.⁷ As contemplated by the new

Chapter 38, the SFC established a framework within which to exercise its new listing related powers and functions (including the establishment of two new listing related committees, namely the SFC (HKEC Listing) Committee and SFC (HKEC Listing) Appeals Committee, which are designed to mirror similar committees within SEHK. At the same time, the SFC put in place a framework to exercise new powers and functions given to it by the Pre-listing MOU to deal with conflicts of interest, which may arise between the commercial interests of HKEx and the performance of regulatory functions generally by any HKEx group company—not limited specifically to the listing related functions. These arrangements all entered into effect on 19 June 2000. The Pre-listing MOU—to which is annexed Section 13 of the *Merger Ordinance and Chapter 38*—is available on the SFC's, SEHK's and HKEx's websites.

The new Chapter 38 deals with a number of matters, which can be divided broadly into three heads.

The first one consists of the powers and functions, rights and obligations of the SFC, SEHK and HKEx in relation to the listing of HKEx. Provisions seek to deal with the most obvious conflict of interest which arises as a result of the listing of HKEx, namely its regulation as an applicant for listing and listed issuer by SEHK, a member of its own group. The approach taken is to provide that the SFC effectively steps into SEHK's shoes and exercises SEHK's listing powers and functions in relation to HKEx in place of and to the exclusion of SEHK.

Furthermore, the new chapter focuses on the powers and functions, rights and obligations of the SFC, SEHK and, where SEHK is prevented from acting in relation to other applicants and listed issuers by reason of a conflict of interest, such other applicants and listed issuers. It is possible

⁷ The above framework was intended to cover all circumstances where conflicts of interest prevent SEHK from acting with respect to an applicant or listed issuer. However, at the time of drafting staff of the SFC and HKEx were focused specifically on HKEx and its pending application for listing on SEHK's Main Board. Unfortunately, the documents, which establish the framework are drafted in a way, which makes it hard to argue that SEHK's Growth Enterprise Market (GEM) is covered by the framework: no express reference to the framework was made in the Rules Governing the Securities on GEM (GEM Listing Rules); and definitions in Chapter 38 of the Main Board Listing Rules and the Pre-listing MOU make reference expressly to the Main Board Listing Rules and not to GEM. As Chapter 38 of the Main Board Listing Rules and the Pre-listing MOU are the source of SFC's powers and functions as a front line regulator in the event of SEHK facing a conflict of interest, it is arguable that technically the SFC cannot deal with GEM without equivalent provision being made for that Board. The Pre-listing MOU has therefore recently been amended to cover GEM and a new Chapter 36 has been inserted in the GEM Listing Rules which is substantially similar to Chapter 38 of the Main Board Listing Rules. While for reasons of simplicity the rest of this section refers to Chapter 38, readers are asked to have in mind that similar rules will also now appear in Chapter 36 of the GEM Listing Rules.

that conflicts between business interests of the HKEx group and regulatory functions performed by SEHK will arise whenever SEHK is dealing with a listed issuer which is either a business competitor or a business associate of HKEx. The aim is to try to avoid a situation where SEHK treats a regulatee which is a business competitor of HKEx more stringently than usual, or a regulatee which is a business associate of HKEx less stringently than usual. In any case of conflict or potential conflict of this kind, agreed procedures contained in the Pre-listing MOU will take effect.

Finally, the Chapter 38 provides the framework within which SFC will exercise the listing functions and powers. For reasons of fairness to HKEx and to be seen to be exercising listing powers and functions in a way similar to that which applies to other applicants for listing and listed issuers, the SFC's listing framework mirrors as closely as possible that set out in the SEHK listing rules. The appropriateness of this approach is confirmed when one recognises that SFC may have to deal with applicants for listing and listed issuers other than HKEx—when SEHK would have a conflict of interest in exercising its regulatory powers and functions which makes it inappropriate for SEHK to exercise those functions—and that to provide different listing structures would be confusing for the market and increase the chance of potentially different outcomes. The framework therefore provides for the establishment of the new Committees mentioned above, and the delegation to them and other persons of powers and functions of the SFC equivalent to those delegated by SEHK to the SEHK Listing Committee, SEHK Listing Appeals Committee, SEHK Listing Division and the Chief Executive of SEHK.

The Pre-Listing MOU contains arrangements designed to ensure the integrity of the securities and futures market and the compliance by HKEx with its obligations as a listed company. In relation to the first category, the MOU includes provisions to address, among others, conflicts of interests and preferential treatment of HKEx. In contrast to relevant provisions of *Chapter 38* of the listing rules described above, which deal with conflicts of interest or potential conflicts of interest in listing matters only, the intention here is to catch conflicts of interest and potential conflicts of interest between business interests and regulatory interests affecting the performance of regulatory functions by HKEx group companies in all regulatory areas. This would include the exercise of regulatory functions by SEHK and HKFE (or their respective subsidiaries) in relation to their Exchange Participants, and by HKSCC (or its subsidiaries) in relation to Clearing Participants.

The procedures for dealing with conflicts of interest require HKEx to put in place a system to ensure that staff discharging regulatory functions can identify conflicts or potential conflicts between business interests and regulatory interests and refer them to a Conflict Committee comprising senior executives of the HKEx group. The Conflict Committee will then refer to the SFC all cases except those which they consider give rise to no conflict or potential conflict of interest. The first point of contact and decision taking level within the SFC will be with the so called “SFC Representatives,” being persons granted delegated powers by the Commission for this purpose. One or more SFC Representative(s) will make a decision as to whether any HKEx proposal for ensuring the proper discharge of regulatory functions is acceptable (in which case HKEx may proceed to handle the matter) or, where appropriate, may determine that the SFC should intervene and exercise the powers given to it under those procedures. If HKEx disagrees with any determination resulting in the latter outcome, it may appeal to the Commission, who will be asked to hear argument from both HKEx and the relevant SFC Representative(s), and then make a determination and issue a written decision which will be binding on both parties.

In all circumstances involving the exercise of a regulatory function where the SFC Representatives or the Commission have determined that it is inappropriate for any HKEx group regulator to act, the SFC may ask for information, give a direction to the regulator concerned or step in and exercise the relevant regulatory powers and functions itself in relation to that matter.

The Pre-listing MOU also sets out administrative and other procedural arrangements to assist SFC to deal with HKEx as a listed company. A number of points are worth noting. First, in order to ensure HKEx is treated no differently from other listed issuers it is intended that the SFC will maintain a dialogue with staff of the Listing Division in order to obtain relevant information regarding SEHK’s normal practices and procedures. Secondly, it is not intended that SFC shall necessarily assume all SEHK’s listing functions in relation to HKEx.

With respect to listed issuers, SEHK exercises listing-related powers and functions both as a regulator and as a securities exchange. It is intended that only the former powers and functions will be exercised by the Commission, and that SEHK will continue to exercise the role of an exchange (which involves, for example, SEHK being the primary source of public information regarding HKEx as a listed company—thus HKEx will continue to file multiple copies of annual and interim financial statements with SEHK, and the SEHK SDI Unit will continue to be the

recipient of returns under the *Securities (Disclosure of Interests) Ordinance*) notification regarding HKEx. Furthermore, the Pre-listing MOU provides that SEHK shall exercise its normal regulatory functions with respect to HKEx in relation to any particular matter or decision that the Commission confirms in writing gives rise to no conflict of interest.

Where the SFC exercises listing-related functions in place of SEHK under *Chapter 38* of the listing rules and the Pre-listing MOU, the proposed SFC listing framework contemplates that the SFC's Executive director of Corporate Finance and certain other staff of the Corporate Finance Division—to be known as the SFC (HKEC Listing) Executive—will take the majority of day-to-day actions and decisions that would otherwise be taken by the SEHK Listing Division. The actions and decisions of the SFC (HKEC Listing) Executive will be subject to review by the SFC (HKEC Listing) Committee and SFC (HKEC Listing) Appeals Committee, in much the same way as actions and decisions of the SEHK Listing Division are subject to review by the SEHK Listing Committee and SEHK Listing Appeals Committee.

The SFC (HKEC Listing) Committee consists of four Executive directors of the Commission (namely those other than the Chairman of the Commission and the Executive director of CF) and four market participants namely. The SFC (HKEC Listing) Appeals Committee consists of the Chairman of the Commission and the nonexecutive directors of the Commission.

The Appendix 1 below contains **Chapters 4 and 5** of *Hong Kong Exchanges and Clearing Limited: Reinforcing Hong Kong's Position as a Global Financial Centre—A Policy Paper* written by the Government of the Hong Kong Special Administrative Region of the People's Republic of China in July 1999, which outlines the business and regulatory framework proposed for HKEx following demutualization.

APPENDIX 1:
Hong Kong Exchanges and Clearing Limited:
Reinforcing Hong Kong's Position as a
Global Financial Centre—A Policy Paper

CHECKS AND BALANCES FOR PUBLIC INTERESTS

Public Functions of Hong Kong Exchanges and Clearing (HKEC)

While the HKEC will be a profit-driven commercial entity, it will also be a key strategic economic asset of Hong Kong. The trading and clearing functions of the securities and futures markets will be centralized in HKEC. Its stock market will inherit from the SEHK the monopoly to operate an exchange-based primary market in Hong Kong. It will also own the only futures exchange and all the clearing operators in Hong Kong. HKEC's performance will have a direct bearing on the success of Hong Kong as a global financial centre.

The role of HKEC in safeguarding the integrity and stability of the financial system of Hong Kong will be crucial. The integrated clearing and settlement unit under HKEC will be one of the most important components of the financial infrastructure of Hong Kong. HKEC has the responsibility to ensure that the risks of the market are properly managed and reduced as far as possible. As witnessed in other markets, the clearing unit is becoming an increasingly technology-intensive operation, making important contributions to the further enhancement of the overall efficiency and stability of the market. Traders, investors and market operators have been increasingly demanding as to the performance of the clearing unit in terms of integrity, reliability and efficiency. Any material failure of the clearing unit would be detrimental to any market, its reputation as well as the confidence of the market users and investors.

The Framework of Checks and Balances

All in all, it is important that the commercial and public objectives of HKEC are properly balanced and that its clearing unit operates in a prudent manner taking risk management and infrastructure

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development as its prime objectives. To ensure that HKEC will be able to live up to this important mandate, strike an appropriate balance between its different objectives and functions, and not abuse its monopoly status to the detriment of the market and investors, a comprehensive framework of checks and balances needs to be put in place.

This will be built on the basis of the current regulation over exchanges and clearing houses provided for under the various securities-related ordinances including the *Securities and Futures Commission Ordinance*, the *Securities Ordinance*, the *Stock Exchanges Unification Ordinance*, the *Commodities Trading Ordinance*, the *Commodities Exchanges (Prohibition) Ordinance* and the *Securities and Futures (Clearing Houses) Ordinance 1*. In addition, a number of specific measures are proposed to address issues that arise primarily from the proposed demutualization and merger.

Corporate Governance

As HKEC will be a commercial entity, its board will have a fiduciary duty to its shareholders to promote the interests of the company. It is neither appropriate nor practicable to maintain supervision over HKEC at a micro-level. It is therefore important that there is an appropriate corporate governance structure for HKEC to ensure that HKEC will be run properly from both the public and commercial perspectives and be able to strike a right balance where these two objectives conflict with each other. Some of the more salient features include the composition of the board, the designation and removal of the Chairman and directors as well as the function and responsibilities of its senior executives. Chapter 5 gives more details in this area.

Prevention of Abuse of Monopoly Status

As a commercial service provider, HKEC is entitled to charge for its services at a profit. Such charges and fees include, *inter alia*, listing fees, trader admission fees, annual/monthly trading fees (i.e., fees collected from traders for access to the trading facilities of HKEC), transaction fees, clearing fees and charges for trade data and other market information. For some of these fees and charges which concern services or products which HKEC provides in a monopolistic environment, the absence of local

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competition may create the possibility of abuse by HKEC by charging unreasonable and excessive fees, which if left unaddressed will not only be unfair to the market users and investors and lead to market inefficiencies but will also reduce Hong Kong's competitiveness internationally.

At the moment, fees and charges of the two Exchanges and HKSCC are set out in their respective rules. The making of or changes to these rules require the approval of the SFC. We believe this system will provide a reasonable safeguard against abuse and at the same time allow sufficient flexibility in implementation which is essential given the diversified business and product base of HKEC. In exercising such approval power, the SFC will develop non-statutory guidelines setting out the factors to be taken into account in considering the level of fees and charges proposed by HKEC. These factors will include, among other things, the comparative transaction costs of Hong Kong and other markets. As a matter of general principle, the level of control should be inversely proportional to the degree of competition available in the local market in respect of the particular services provided by HKEC. For services which are already subject to adequate market competition, there would appear to be no apparent need for SFC supervision as the risk of abuse is most unlikely.

It should also be noted that with the removal of the membership structure following demutualization of the exchanges, the level of commission charged by traders should be a matter essentially between traders and their clients.

Risk Management for the Market

As noted above, risk management of the clearing unit is an important function of HKEC that will have profound implications for the rest of the financial system. To ensure that HKEC will perform such function in a prudent manner and that risk management-related decisions will not be unduly affected by profit-related considerations, the policy-making function for the clearing unit will be entrusted to a high-power, independent governance committee within HKEC. The committee should be chaired by the Chairman of HKEC personally and comprise a majority of external board members of HKEC, including representatives of market regulators including the SFC and the Hong Kong

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Monetary Authority, relevant market experts and public interest representatives. The decision of the committee will prevail unless overruled by, say, a two-third majority of the Board of HKEC. On matters of fundamental importance to the risk management function, the decisions of the committee will require the consent of the SFC. The power and constitution of this committee will be spelt out clearly under the law and repeated in the constitution of HKEC.

Shareholding Limit

A shareholding limit of 5% will be put down in the law to prevent control of HKEC by any individual parties or parties acting in concert. The limit can be waived by the SFC in consultation with the Financial Secretary where it can be demonstrated that an exemption is in the interest of the public and the market, such as under an equity alliance with an overseas exchange. Conditions may be attached to such exemptions where deemed appropriate. In addition, any changes in the corporate structure involving changes in the equity ownership of the HKEC's subsidiaries will require the approval of the SFC in consultation with the Financial Secretary.

HKEC as a Listed Company

HKEC as a listed company on its own stock market will be regulated by the SFC to avoid conflict of interest and to ensure a level playing field between HKEC and other listed companies which will be subject to the listing rules administered by HKEC.

A Streamlined Governance Model

The Principle

HKEC has both commercial and public interests. The primary consideration in designing its corporate governance structure is to ensure that these interests are properly balanced. It should afford sufficient protection for the public interest vested in HKEC on the one hand and provide the necessary flexibility and incentive for HKEC to pursue its commercial interest on the other.

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In arriving at the proposed model below, it is recognised that as the ownership of HKEC becomes more diversified through listing and trading of its shares on the market, a higher proportion of the members of the board of HKEC should be representatives of the shareholders of HKEC, whose interests should be consistent with the interests of HKEC as a whole. This means that the board composition of HKEC has to be adjusted as its ownership diversifies.

The Business Structure of HKEC

After the merger, HKEC will become a public holding company and the Exchanges and the Clearing Houses will become its wholly-owned subsidiaries. Chapter 3 sets out the business and operation structures of HKEC, including the functions of the Board and the main BUs and administrative and functional departments under HKEC. This Chapter focuses on the structure of the board of HKEC and the various governance committees and consultative panels.

Formation of HKEC

As a party to the merger, HKEC is required under the law to exist prior to the circulation of the scheme of arrangement documents, which is expected to take place around mid-August 1999. At its inception, HKEC will have no substantive business. In fact, there are limited functions that need to be performed by the HKEC board at this particular stage, apart from the legal functions required under the law and the Takeovers Code to complete the merger process and the preparatory work for the transitional phase after voting by members of the two exchanges but before the merger actually takes place (which is subject to the enactment of the enabling legislation). As perhaps the natural and obvious guardian of the interest of HKEC at this stage, it is considered appropriate that HKEC will be incorporated as a private company under the Financial Secretary Incorporation. After the merger, the government will cease to hold any shares of HKEC, or at most maintain only a deminimized shareholding.

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The HKEC Board

The HKEC board must balance two main interests, namely the shareholders' interests, and the market and public interests. The design in the evolution of the board structure as detailed below also takes into account the consideration that as the ownership of HKEC diversifies over time, the representation of the shareholders' interests in the board can also be expected to increase. In addition, such evolution also reflects the four distinct phases in the early years of HKEC that require corresponding adjustments in the composition of its board.

The following sets out the preferred composition of the board of HKEC at four different stages (a summarized version can be found as follows).

BOARD COMPOSITION TRANSITION

Groups	Preparatory Board		Inaugural Board	Second Board
	July 1999	Sept. 1999	March 2000	2003
Shareholders	0	0	6	6
Public/market representatives*	4	7	8	5–8**
CEO	0	0	1	1
Total board members	4	7	15	12–15

* Market representatives include traders, fund managers and other groups of intermediaries and market-related professionals.

** Depending on commercial and operational needs of HKEC as well as the diversification of shareholding, subject to review in 2001/2002.

July 1999 *Preparatory board.* As noted above, HKEC is legally required to be formally established prior to the circulation of the scheme of arrangement documents. At this stage, the board should be relatively small—comprising four members, including the Chairman, all of whom would be appointed by the government, representing in essence the public and market interests.

October 1999 Assuming that members of both SEHK and HKFE vote for the merger, three additional directors will be appointed by the government to the preparatory board, one from each of the two exchanges and the HKSCC as representatives of their respective interests in HKEC during the transitional period prior to completion of the merger. Appointment of these directors prior to the voting is considered inappropriate as it may give rise to potential conflict of interests.

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continued

- March 2000** *Inaugural board.* When the merger is completed, the board will be enlarged to include six additional directors to be returned by shareholders of HKEC (i.e., members of the two exchanges). The number of directors to be appointed by the government to the HKEC board representing public and market interests will be increased from seven to eight. The CEO of HKEC would be an ex-officio member of the board, giving a total of 15 directors on the inaugural board.
- 2003** *Second board.* It is believed that as HKEC matures, the size of its board could be reduced. In addition, as the ownership of HKEC becomes more diversified over time, it is appropriate to increase the representation of shareholder interests on the board, while still maintaining a reasonable representation of public and market interests through directors appointed by the government. Consequently, when the term of the inaugural board expires, the size of the board could be reduced from fifteen to, say, twelve. The number of directors to be returned by shareholders would remain at six (hence accounting for 50% of the board size) and the number of directors to be appointed by the government could be reduced. The CEO of HKEC would remain an ex-officio member of the board. However, depending on the actual commercial and operational needs of HKEC at the time and the pace of diversification of shareholding in HKEC, there may be grounds to maintain the board on a similar scale beyond 2003. The matter should be reviewed in say, 2002, by the board of HKEC before a final decision is made.
-

Chairman

The chairman of HKEC assumes key responsibilities not only for HKEC but also for the wider public interests vested in HKEC. He/she will focus on chairing the board, supervising the CEO and the COO and optimizing relationships with external constituencies at the policy level. The chairman should be nonexecutive to ensure that he/she is best placed to balance the interests of HKEC, its shareholders and the public.

The chairman of the preparatory board will be appointed by the government. For the inaugural board and thereafter, the chairman will be elected by the directors of the board, subject to endorsement by the Chief Executive of the HKSAR. The board will be empowered to remove the chairman on a two-third majority. The Chief Executive of the HKSAR may also remove the chairman on grounds of public interest or interest of the investing public. Each term of the chairmanship will last for three years. The serving chairman is eligible for re-election for the

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chairmanship next term. The chairman must not stand for election immediately after having served two consecutive terms.

Directors of HKEC Board

The HKEC board will comprise directors to be returned by shareholders, directors appointed by the government and the CEO as an ex-officio director. The preparatory board will also act as the nominating committee, which will be responsible for returning no less than nine candidates for election by shareholders of HKEC as directors of its inaugural board. For the second board and thereafter, both the incumbent board and shareholders of HKEC may nominate candidates for election by shareholders as directors. In the case of nomination by shareholders, such nomination must receive a reasonable level of support from the shareholders either expressed as a percentage of shareholding or number of shareholders.

The four governance committees consist of the Audit, Risk Management, Listing Matters and Users Appeal Committees. The Audit Committee performs the corporate supervision and checking function for the HKEC group of companies as a whole including its subsidiaries. It would be composed of three board members (one of whom would chair the committee) and a number of external experts and market participant representatives. Listing Matters and Users Appeal Committees would be composed purely of external members together with two to three public interest representatives. All governance committees report directly to the board. The Risk Management Committee is distinct in its independent nature commensurate with the important tasks it will perform.

Three consultative panels represent the market participants, one for each of HKEC's main activities: Cash Market, Futures and Derivatives, and Clearing. Each of these panels would be composed of three board members (one of whom would chair the panel) and a number of external experts and market participant representatives. The consultative panels would also report directly to the board.

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BOARD COMMITTEES AND PANELS

	Committees	Key Tasks	Composition
Governance Committees	Audit	<ul style="list-style-type: none"> • review financial statements before board. • nominate external auditors. • monitor the structure of internal controls. 	<ul style="list-style-type: none"> • 3 board members (including 1 as chairman). • 3 to 5 external members (appointed by board).
	Risk Management	<ul style="list-style-type: none"> • review risk management procedures. • assess changes on minimum capital reserve requirement, margining levels, counter party risk limit. 	<ul style="list-style-type: none"> • 3 board members (including 1 as chairman). • 3 to 5 external members including cross-market government experts and public interest representatives (appointed by the board).
	User Appeal	<ul style="list-style-type: none"> • adjudicate disciplinary matters concerning participants and listed companies. 	<ul style="list-style-type: none"> • 1 board member • 5 to 6 external market professionals (e.g., lawyers, accountants). • 2 to 3 public interest representatives.
	Listing Matters	<ul style="list-style-type: none"> • adjudicate appeals on listing decisions and other listing matters. 	<ul style="list-style-type: none"> • 1 board member. • 5 to 6 external market professionals (e.g., lawyers, accountants). • 2 to 3 public interest representatives.
Consultative Panels	Cash Market Derivatives Market Clearing	<ul style="list-style-type: none"> • provide market expertise on: international trends; intermediary/issuer/investors needs; technology challenges; new product opportunities. • act as sounding board for: policy decisions; strategic initiatives; major investments. 	<ul style="list-style-type: none"> • 10 members for each committee of which 2 are board members. • selected from representatives of market participants and industry experts. • selection process to be determined.

APPENDIX 2:

***Memorandum of Understanding for the Listing
of Hong Kong Exchanges and Clearing Limited on
the Stock Exchange of Hong Kong Limited***

between

***Securities and Futures Commission
Hong Kong Exchanges and Clearing Limited***

and

The Stock Exchange of Hong Kong Limited

19th June 2000

Appendix 2: Memorandum of Understanding for the Listing of HKEx on SEHK

Memorandum of Understanding for the Listing of HKEx on SEHK between:

- (1) Securities and Futures Commission of 12th Floor, Edinburgh Tower, The Landmark, 15 Queen’s Road Central, Hong Kong (SFC);
- (2) Hong Kong Exchanges and Clearing Limited of 12th Floor, One Memorandum of Understanding for the Listing of HKEx on SEHK International Finance Centre, 1 Harbour View Street, Central, Hong Kong (HKEx); and
- (3) The Stock Exchange of Hong Kong Limited of 1st Floor, One and Two Exchange Square, Central, Hong Kong (SEHK).

1. INTERPRETATION

1.1 Definitions

1.1.1 Unless the context otherwise requires, the following expressions shall have the following respective meanings:

Listing rules	Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited
Merger Ordinance	The <i>Exchanges and Clearing Houses (Merger) Ordinance</i> (Cap. 555)
MOU	This Memorandum of Understanding
Relevant Ordinances	The <i>Securities and Futures Commission Ordinance</i> (Cap. 24), Part II of the <i>Companies Ordinance</i> (Cap. 32) (insofar as that part relates, whether directly or indirectly, to the performance of functions by the SFC in relation to prospectuses and purchase by a company of its own shares) and part XII of that ordinance (insofar as that part relates, whether directly or indirectly, to the performance of functions by the SFC in relation to prospectuses), the <i>Securities Ordinance</i> (Cap. 333), the <i>Commodity Exchanges (Prohibition) Ordinance</i> (Cap. 82), the <i>Commodities Trading Ordinance</i> (Cap. 250), the <i>Merger Ordinance</i> , the <i>Protection of Investors Ordinance</i> (Cap. 335), the <i>Stock Exchanges Unification Ordinance</i> (Cap. 361), the <i>Securities and Futures (Clearing Houses) Ordinance</i> (Cap. 420), the <i>Securities (Disclosure of Interests) Ordinance</i> (Cap. 396) and the <i>Securities (Insider Dealing) Ordinance</i> (Cap. 395)

Appendix 2: Memorandum of Understanding for the Listing of HKEX on SEHK

1.2 Construction

1.2.1 In this MOU, where the context admits:

- (a) words and expressions, the definitions of which are contained or referred to in the *Merger Ordinance* or the listing rules, shall be construed as having the meanings so attributed to them;
- (b) references to statutory provisions shall be construed as references to those provisions as respectively amended or re-enacted or as their application is modified by other provisions (whether before or after the date hereof) from time to time and shall include any provisions of which they are a re-enactment (whether with or without modification); and
- (c) words importing the singular meaning include the plural meaning and vice versa and words of one gender include both other genders, and words denoting natural persons include corporations and firms and vice versa.

2. STATUS OF THE PARTIES AND THIS MOU

2.1 Status of the Parties

- 2.1.1 The SFC is the statutory regulator of the securities and futures markets in Hong Kong. The relevant ordinances include provisions allowing the SFC to oversee the operations of HKEx and SEHK. The *Merger Ordinance* provides, inter alia, for the SFC to perform certain functions and exercise certain powers in the event of HKEx's listing.
- 2.1.2 HKEx is a recognized exchange controller and SEHK is a company of which HKEx is the controller.
- 2.1.3 SEHK is a wholly owned subsidiary of HKEx. It is a recognized exchange company which operates the Stock Exchange of Hong Kong and is the front line regulator of listed companies in Hong Kong.

Appendix 2: Memorandum of Understanding for the Listing of HKEx on SEHK

2.2 Purposes of this MOU

2.2.1 Pursuant to section 13 of the *Merger Ordinance*, HKEx may become a listed company provided that the requirements of the section are complied with. In particular, listing may not take place until the SFC is satisfied that:

- (a) rules made under section 34 of the *Stock Exchanges Unification Ordinance* (Cap. 361) adequately deal with possible conflicts of interest that might arise if HKEx were to be a listed company; and
- (b) HKEx has entered into arrangements with the SFC that adequately ensure, inter alia, the integrity of the securities and futures market on the relevant Exchange Company and the compliance with obligations as a listed company which would fall on HKEx if it were to become a listed company.

Section 13(4) of the *Merger Ordinance* provides that the SFC shall have such powers and functions as are provided for it under rules and arrangements referred to in paragraphs (a) and (b) above respectively. The provisions of section 13 are set out in Appendix A.

2.2.2 HKEx proposes to become a listed company. This MOU sets out arrangements agreed between the parties, as contemplated by section 13 of the *Merger Ordinance*. SEHK has agreed to become a party to this MOU to facilitate the implementation of those arrangements. The SFC has the powers and functions provided in this MOU.

2.2.3 The parties recognize that it is important that there be consistency of outcome and timing as far as possible between:

- (a) SEHK in its administration and enforcement of the Rules of the Exchange in relation to HKEx's securities and other securities;
- (b) SEHK in its administration and enforcement of the listing rules in relation to all applicants for listing and listed issuers other than HKEx (other applicants and issuers); and

Appendix 2: Memorandum of Understanding for the Listing of HKEX on SEHK

- (c) the SFC in its administration and enforcement of the listing rules in relation to HKEx.

2.2.4 Provisions of this MOU set out the way the parties will relate to each other in relation to:

- (a) HKEx's and other applicants and issuers' compliance with the listing rules;
- (b) SEHK's enforcement of the Rules of the Exchange in relation to HKEx's securities and those of other applicants and issuers;
- (c) the SFC's supervision and regulation of HKEx as a listed issuer and, where a conflict of interest arises, other applicants and issuers;
- (d) conflicts of interest which may arise between the interests of HKEx as a listed company and companies of which it is the controller, and the interests of such companies in the proper performance of regulatory functions; and
- (e) market integrity.

3. LISTING ARRANGEMENTS

3.1 General Powers and Rights

3.1.1 The SFC shall, instead of SEHK, take all actions and make all decisions in relation to HKEx that would be taken by SEHK in the case of other applicants and issuers except in the case of any action or decision in respect of which the SFC states in writing that it is satisfied that a conflict of interest will not arise if that action or decision were to be taken or made, as the case may be, by SEHK.

3.1.2 Without prejudice to the terms of this MOU, the parties shall have the powers and functions, rights and obligations (as the case may be) provided for them respectively in *Chapter 38* of the listing rules. The powers and functions of the SFC referred

Appendix 2: Memorandum of Understanding for the Listing of HKEx on SEHK

to in this MOU (including those in *Chapter 38* of the listing rules) are hereinafter referred to as “SFC (HKEx Listing) Powers”.

3.2 Listing of HKEx

- 3.2.1 The SFC will receive and consider HKEx’s application for listing on the Stock Exchange of Hong Kong and any pre-application documents. The SFC may, subject to HKEx’s rights of appeal, reject HKEx’s application or approve (with or without conditions) the application. If the application is approved, the SFC will be responsible for the supervision of HKEx’s compliance with the listing rules as a listed issuer.
- 3.2.2 In relation to HKEx’s application for listing, the SFC will advise SEHK of any administrative steps it reasonably requires SEHK to take on its behalf. The SFC shall not require SEHK to take steps which SEHK would not take with respect to other applicants for listing. SEHK will carry out the administrative steps within the time period and in a like way to that which it would do with respect to other applicants for listing.

3.3 Ongoing Listing Procedures

- 3.3.1 If HKEx’s application for listing is approved the SFC shall, in relation to HKEx, have all the powers and functions that SEHK has in relation to a listed issuer, except SEHK’s power to make listing rules pursuant to section 34 (1) of the *Stock Exchanges Unification Ordinance* (Cap. 361). SEHK shall have, and be entitled to exercise, its normal powers and functions in the case of any action or decision in respect of which the SFC has stated in writing that a conflict of interest will not arise if that action or decision were to be taken or made, as the case may be, by SEHK.
- 3.3.2 The SFC has established a framework for exercising those SFC (HKEx Listing) Powers which are concerned with listing matters. Such framework has been set out in *Chapter 38* of

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the listing rules. The provisions of Chapter 38 are set out in Appendix 2. The parties acknowledge that as *Chapter 38* constitutes listing rules it may be changed pursuant to section 34 of the *Stock Exchanges Unification Ordinance* (Cap. 361). The version of *Chapter 38* appended hereto is attached for ease of reference only and any change to Chapter 38 after the entry into force of this MOU will not constitute an amendment of this MOU requiring an Addendum.

3.3.3 SEHK will not, unless requested by the SFC and agreed by SEHK:

- (a) be bound to monitor the listing rules in relation to HKEX;
- (b) enforce the listing rules in relation to HKEX; or
- (c) except as provided in clause 5, make any referral under its statutory obligations to the SFC in relation to HKEX.

3.3.4 SEHK will nominate the person or persons in the Listing Division who:

- (a) from time to time, may be contacted by the SFC to discuss Listing Rule policy or administration or any other matters in relation to HKEX as a listed issuer (e.g., enforcement issues or general waiver policy); and
- (b) will give the SFC the information referred to in clause 3.5.1.

3.3.5 All communications and contacts between the Listing Division and the SFC in relation to any matters referred to in clause 3.3.4 are deemed confidential and shall not be disclosed to any third party by SEHK (other than its internal and external legal or other professional advisers for the purposes of obtaining advice, or under compulsion of law) without the SFC's prior written consent. The SFC acknowledges that the relevant persons in the Listing Division may also perform functions for HKEX as the parent company of SEHK. However, the Listing Division shall not disclose the

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communications and contacts with the SFC in relation to HKEx to other personnel of HKEx other than the Chief Executive of HKEx who shall thereupon be subject to the same confidentiality obligation.

3.3.6 SEHK will take action as required by the SFC in relation to:

- (a) the admission to, suspension or removal from, listing on the Stock Exchange of Hong Kong of HKEx's securities; and
- (b) the suspension or resumption on SEHK's trading system of trading in HKEx's securities.

SEHK will do so within the respective time limits as reasonably prescribed by the SFC or in lieu thereof in a timely manner, and in the way as reasonably prescribed by the SFC or in lieu thereof and to the extent practicable, in a like way to that which it would do with respect to other listed issuers.

3.3.7 In relation to HKEx as a listed issuer, the SFC will advise SEHK of any administrative steps it reasonably requires SEHK to take on its behalf. The SFC shall not require SEHK to take steps which SEHK would not take with respect to other listed issuers. SEHK will carry out the administrative steps within the time period and in a like way to that which it would do in respect of other listed issuers.

3.4 Company Announcement Procedures

3.4.1 The SFC will advise SEHK of any administrative steps it reasonably requires SEHK to take on its behalf in relation to any division of the decision-making and administrative steps involved in HKEx issuing company announcements. The SFC shall not require SEHK to take steps which SEHK would not take with respect to other listed issuers. SEHK will carry out the administrative steps within the time period and in a like way to that which it would do with respect to other listed issuers.

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3.4.2 If a document for release to the market is served on SEHK that should have been served on the SFC acting in the place of SEHK as the regulator of HKEX in respect of listing matters, SEHK will:

- (a) as soon as reasonably practicable, give the document to the SFC; and
- (b) not release or otherwise deal with the document or copy thereof except in accordance with administrative steps specified by the SFC pursuant to this clause 3.4.

However, unless otherwise agreed between SEHK and the SFC, third party disclosures that are made under the listing rules and any of the relevant ordinances (e.g., a notice by any person pursuant to the *Securities (Disclosure of Interests) Ordinance* (Cap. 396)) are not affected by this clause, and SEHK will deal with any such release in accordance with its normal procedures with respect to listed issuers.

3.4.3 The SFC may specify documents, or classes of documents, required by the relevant ordinances to be served on a securities exchange that will not be subject to this clause 3.4.

3.5 Listing Rule Waiver Procedures

3.5.1 When the SFC receives a Listing Rule waiver application from HKEX, the Listing Division shall at the request of the SFC as soon as reasonably practicable provide the SFC with the following:

- (a) access to SEHK's internal waivers database;
- (b) if asked, background papers retained by SEHK in relation to the waiver decisions in (a); and
- (c) if asked, advice on SEHK's policy, or administration, in relation to the relevant Listing Rule.

The above information may be provided wholly or in part by way of a direct data link.

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3.5.2 Regulatory information given to the SFC in connection with an application for a waiver will be treated confidentially by the SFC.

3.5.3 Waivers granted and not granted to HKEx will be recorded by SEHK in its internal database. The SFC will give SEHK a copy of the entry to be recorded.

3.6 Fees and Expenses

3.6.1 HKEx will pay the SFC the following fees:

- (a) in relation to HKEx's listing application, and ongoing listing, any fees required by the listing rules; and
- (b) in comparable circumstances applying to HKEx, any fee that would have been payable to SEHK by other applicants and issuers in connection with their listing on the Stock Exchange of Hong Kong.

3.6.2 The SFC will invoice HKEx and otherwise use the same timing and procedures that SEHK uses in relation to the payment of fees by other listed issuers.

3.6.3 The SFC will pay to SEHK, on written request from SEHK accompanied by adequate supporting information, its reasonable costs and out-of-pocket expenses incurred in performing administrative steps for the SFC hereunder. The aggregate amounts payable by the SFC shall not exceed the amount of the fees it receives from HKEx under clause 3.6.1.

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4. CONFLICTS OF INTEREST AND MARKET INTEGRITY

4.1 Conflicts of Interest

4.1.1 Section 13(2)(a) of the *Merger Ordinance* requires the SFC to be satisfied that HKEx has put in place procedures (detailing among other things the powers and functions, rights and obligations of the SFC and HKEx respectively) to deal with conflicts of interest that may arise between, on the one hand, the interests of HKEx as a listed company and/or the companies of which it is the controller, and on the other hand, the interests of the proper performance of regulatory functions by such companies. The parties have agreed those procedures as are set out in Appendix C.

4.2 Market Integrity

4.2.1 HKEx and the SFC acknowledge that, with the coming into effect of the *Merger Ordinance*, there is a need to formalize new arrangements as soon as reasonably practicable for the effective discharge of their respective responsibilities in relation to SFC oversight of HKEx and its subsidiaries, supervision of Exchange Participants and market surveillance to reduce any areas of duplication of function, to facilitate a smooth and cooperative working relationship and to enable the SFC more effectively to discharge its statutory obligation of supervision and that the SFC has supplied HKEx with a draft of a proposed Memorandum of Understanding (MOU) covering these matters as a basis of further discussions. The parties agree to work together in good faith and in a spirit of mutual cooperation to consider that draft and to finalize as quickly as reasonably practicable an appropriate Memorandum of Understanding.

4.2.2 In the interim, the parties agree that each of them will continue to observe existing Memoranda of Understanding, arrangements and practices delineating their respective areas

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of operation and the information-sharing arrangements between them, including those arrived at in an exchange of correspondence in relation to disciplinary arrangements and information-sharing immediately prior to the coming into force of the *Merger Ordinance*.

5. MARKET SURVEILLANCE

- 5.1** Where SEHK, in the course of its surveillance of Exchange Participants and listed issuers or as a result of complaints or market intelligence, detects unusual market activity (whether of an Exchange Participant, their representative or clients) involving HKEx's securities which reveals a possible breach of any of the relevant ordinances, business rules or conditions of a license, SEHK will immediately inform the SFC. This clause 5.1 does not require SEHK to undertake surveillance functions or actions which it does not already undertake at the date hereof.
- 5.2** If SEHK informs the SFC under clause 5.1, it will then inform the SFC of SEHK's findings.

6. MISCELLANEOUS

6.1 Confidentiality

- 6.1.1** None of the parties will disclose any confidential information obtained under this MOU to a third party unless:
- (a) prior written consent of the other parties is obtained; or
 - (b) it is required or authorised by law to disclose the information; or
 - (c) the information has come into the public domain otherwise than as a result of its breach of this clause.

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6.2 Strategic Review

6.2.1 A strategic review of this MOU will take place once each year at a place, date and time to be agreed. It will be conducted by senior executive officers of the parties. It will address any matters that any party regards as necessary or desirable to review.

6.3 Operational Meeting

6.3.1 The parties will meet at the request of any party to discuss the operation of this MOU, any systems access, information access, and any other operational matters that any party regards as important to discuss.

6.3.2 Nothing in this MOU should be construed as restricting the ability of the SFC to raise with HKEx, or HKEx to raise with the SFC, any measures that seem necessary or desirable to enhance the operation of this MOU.

6.4 Amendment

6.4.1 If it becomes apparent that it is necessary or desirable to amend this MOU or any Addendum each of the parties will use its reasonable endeavours to agree on appropriate amendments as soon as practicable thereafter.

6.5 General Co-operation and Assistance

6.5.1 HKEx, SEHK and the SFC will provide each other with such co-operation and assistance in good faith as is necessary or desirable to achieve the objectives of section 13 of the *Merger Ordinance*, this MOU and *Chapter 38* of the listing rules.

6.5.2 The parties acknowledge that:

- (a) the SFC may determine at any time that it is necessary or desirable to change or supplement the rules in *Chapter 38* of the listing rules; or

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- (b) either the SFC or HKEx may determine at any time that it is necessary or desirable to change or supplement the arrangements in this MOU, in order to continue to satisfy the requirements of section 13 of the *Merger Ordinance*. In such event, the parties will co-operate to ensure that the new or revised rules are made and the new or revised arrangements are entered into. Nothing in this sub-clause shall derogate from SEHK's general rule making powers under section 34 of the *Stock Exchanges Unification Ordinance* (Cap. 361).

6.5.3 In the course of exercising its powers and functions under section 13 of the *Merger Ordinance*, the SFC may request that SEHK (or another company of which HKEx is the controller) perform such administrative tasks on its behalf as the SFC reasonably considers appropriate for the purposes of that section, *Chapter 38* of the listing rules, this MOU or any addendum. HKEx shall procure that the relevant company will properly perform such tasks within the respective time limits as reasonably prescribed by the SFC or in lieu thereof in a timely manner, and in the way as reasonably prescribed by the SFC or in lieu thereof and to the extent practicable in a like way to that which it would do with respect to other listed issuers.

6.5.4 In relation to any request of the SFC under paragraph 6.5.3:

- (a) the SFC will state in writing that it is satisfied that a conflict of interest will not arise if that task is performed by the relevant company; and
- (b) HKEx will inform the SFC if the relevant task is not one which the relevant company would perform with respect to other persons it regulates and the SFC and HKEx will thereupon discuss whether and how the task should be performed.

6.5.5 HKEx shall procure that SEHK shall comply with the provisions of and promptly perform its obligations under this MOU.

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6.5.6 As soon as reasonably practicable following a request of the SFC:

- (a) SEHK will provide to the SFC information relating to HKEx and its securities (and/or where a conflict of interest may exist, those of any company regulated by SEHK) which is in the possession or control of SEHK; and
- (b) HKEx will provide to the SFC information relating to holders of voting rights in HKEx which is in its possession or control.

6.6 Effect on Other Arrangements

6.6.1 The Amended and Restated Memorandum of Understanding Governing Listing Matters dated 6 March 2000 between the SFC and SEHK shall have effect subject to any conflicting provisions of this MOU or of *Chapter 38* of the listing rules.

6.6.2 In the event of there being any conflict between the provisions of this MOU and/or *Chapter 38* of the listing rules and any other arrangements entered into between the SFC and HKEx and/or SEHK with respect to listing matters, the provisions of this MOU and/or *Chapter 38* of the listing rules shall prevail.

6.7 SFC May Delegate Powers and Functions

6.7.1 The SFC may delegate its powers and functions under this MOU and *Chapter 38* of the listing rules pursuant to section 9 of the *Securities and Futures Commission Ordinance* (Cap. 24).

7. EFFECTIVE DATE AND TERMINATION OF MOU

7.1 **This MOU shall come into force on the date hereof or such other date as may be agreed in writing between the SFC and HKEx.**

7.2 **This MOU will continue in force until:**

Appendix 2: Memorandum of Understanding for the Listing of HKEx on SEHK

- (a) HKEx ceases to be a listed issuer for the purposes of the listing rules; or
- (b) subject to the *Merger Ordinance*, all parties agree in writing to terminate this MOU; or
- (c) terminated by the SFC pursuant to clause 7.3.

Provided that the termination shall be without prejudice to any rights which any party may have against any other party arising prior to such termination.

7.3 In case of a failure or refusal on the part of HKEx or SEHK to comply fully with the provisions of, or to perform its respective obligations under this MOU, then the SFC may, in its absolute discretion, take any action it considers necessary or desirable, and in particular the SFC may (in addition and without prejudice to its statutory powers) unilaterally terminate this MOU by giving not less than 14 days written notice (which shall include the reason or reasons for such termination) to HKEx and SEHK respectively.

DATED this 19th day of June

SIGNED FOR AND ON BEHALF OF THE)
SECURITIES AND FUTURES COMMISSION)

BY Andrew L.T. SHENG) Sgd. A. Sheng

authorized so to do by resolution of the)
Securities and Futures Commission)
on 19th June 2000)

Appendix 2: Memorandum of Understanding for the Listing of HKEX on SEHK

SIGNED FOR AND ON BEHALF OF)
HONG KONG EXCHANGES AND)
CLEARING LIMITED)

BY LEE Yeh Kwong, Charles) Sgd. Y.K. Lee
authorized so to do by resolution of its)
Board of Directors on 14th June 2000)

SIGNED FOR AND ON BEHALF OF)
THE STOCK EXCHANGE OF)
HONG KONG LIMITED)

BY KWONG Ki Chi) Sgd. K.C. Kwong
authorized so to do by resolution of its)
Board of Directors on 14th June 2000)

APPENDIX 3:
**Section 13 of the Exchanges and Clearing Houses
(Merger) Ordinance**

13. Provisions applicable where recognized exchange controller, etc, seeks to be listed company
- (1) In this section—
- “**listed company**” means a listed company within the meaning of section 2(1) of the *Securities and Futures Commission Ordinance* (Cap. 24);
 - “**relevant company**” means a company of which the relevant recognized exchange controller is the controller;
 - “**relevant recognized exchange controller**” means a recognized exchange controller which is the controller of the Stock Exchange Company;
 - “**Stock Exchange Company**” means the Stock Exchange Company within the meaning of section 2(1) of the *Securities and Futures Commission Ordinance* (Cap. 24).
- (2) The relevant recognized exchange controller, or a relevant company, shall not become a listed company unless and until the Commission states in writing that it is satisfied that—
- a) subject to subsection (3), rules made under section 34 of the *Stock Exchanges Unification Ordinance* (Cap. 361) adequately deal with possible conflicts of interest that might arise if the relevant recognized exchange controller or relevant company, as the case may be, were to be a listed company; and
 - b) the relevant recognized exchange controller or relevant company, as the case may be, has entered into arrangements with the Commission that adequately ensure—

Appendix 3: Section 13 of the Exchanges and Clearing Houses (Merger) Ordinance

- (i) the integrity of the market in securities or futures contracts traded on or through the Exchange Company concerned; and
 - (ii) the compliance with obligations as a listed company which would fall on the relevant recognized exchange controller or relevant company, as the case may be, if it were to become a listed company.
- (3) Rules referred to in subsection (2)(a) shall make provision to the effect that the Commission shall, instead of the Stock Exchange Company, take all actions and make all decisions in relation to the relevant recognized exchange controller or relevant company that would be taken by the Stock Exchange Company in the case of a company that was neither a recognized exchange controller nor a relevant company except in the case of any action or decision in respect of which the Commission states in writing that it is satisfied that a conflict of interest will not arise if that action or decision were to be taken or made, as the case may be, by the Stock Exchange Company.
- (4) By virtue of this section, the Commission shall have such powers and functions as are provided for it under—
- a) rules made for the purposes of subsections (2)(a) and (3);
 - b) arrangements referred to in subsection (2)(b).
- (5) Where a fee is payable to the Stock Exchange Company by a person for the taking of an action or the making of a decision which may be taken or made, as the case may be, by the Commission by virtue of subsections (2)(a) and (3), then, notwithstanding any other enactment or rule of law, that person shall pay that fee to the Commission in any case where the Commission takes that action or makes that decision, as the case may be, by virtue of those subsections.

APPENDIX 4:
**Chapter 38 of the Rules Governing the
Listing of Securities on the Stock Exchanges of
Hong Kong Limited**

Listing of HKEC

38.01 This Chapter sets out requirements that must be satisfied for the securities of HKEC to be listed on the Exchange. HKEC is the holding company of the Exchange and a recognized exchange controller within the meaning of the Exchanges and *Clearing Houses (Merger) Ordinance* (Cap. 555) (*Merger Ordinance*). The exchange is a company of which HKEC is the controller within the meaning of the *Merger Ordinance*.

38.02 In the context of the listing of HKEC, and as contemplated by section 13 of the *Merger Ordinance*:

- (1) the exchange has included this chapter in the Exchange; and
- (2) HKEC and the exchange have entered into a Memorandum of Understanding (MOU) with the commission.

Powers and Functions of the Commission and the Exchange

38.03 Without limitation of the Commission's general powers and functions in relation to listing matters, the Commission has the following powers and functions in relation to HKEC's application for listing and status as a listed issuer:

- (1) the powers and functions that the Exchange has in relation to an applicant for listing. The Exchange must not exercise powers or perform functions in relation to HKEC's own application, except in the case of any action or decision in respect of which the Commission states in writing that it is satisfied that a conflict of interest will not arise if that action were taken or decision made by the Exchange;
- (2) if HKEC's application for listing is approved, the powers and functions

Appendix 4: Chapter 38 of the Rules Governing the Listing of Securities on the Stock Exchanges of Hong Kong Limited

that the Exchange has in relation to a listed issuer, except the power to make listing rules. The Exchange must not exercise powers or perform functions that this rule gives to the Commission, except in the case of any action or decision in respect of which the Commission states in writing that it is satisfied that a conflict of interest will not arise if that action were taken or decision made by the Exchange.

38.04 In circumstances where the Commission has stated in writing that a conflict of interest will not arise if an action or decision were to be taken or made by the Exchange, the Exchange shall have, and be entitled to exercise, its normal powers and functions in taking the relevant action or making the relevant decision.

The SFC (HKEC Listing) Committee, SFC (HKEC Listing) Appeals Committee and SFC (HKEC Listing) Executive

38.05 The Commission has established a framework for exercising its listing related powers and functions with respect to HKEC. The framework comprises committees established by the Commission pursuant to section 6 of the *Securities and Futures Commission Ordinance* (Cap. 24) and persons who will exercise with respect to HKEC applicable powers and functions, in so far as is practicable and applicable, in a like manner to the Listing Committee, Listing Appeals Committee, Listing Division and the Chief Executive of the Exchange, respectively. The relevant committees and persons are:

- (1) the SFC (HKEC Listing) Committee, which shall exercise applicable powers and functions equivalent to those of the Listing Committee including applicable powers and functions equivalent to those of the Listing (Review) Committee;
- (2) the SFC (HKEC Listing) Appeals Committee, which shall exercise applicable powers and functions equivalent to those of the Listing Appeals Committee;
- (3) the SFC (HKEC Listing) Executive, comprising the Executive Director in charge of the Corporate Finance Division of the Commission and members of staff of the Corporate Finance Division of the

*Appendix 4: Chapter 38 of the Rules Governing the Listing of Securities
on the Stock Exchanges of Hong Kong Limited*

Commission, which shall exercise applicable powers and functions equivalent to those of the Listing Division;

- (4) the Executive Director in charge of the Corporate Finance Division of the Commission, who shall exercise applicable powers and functions equivalent to those of the Executive Director – Listing and the Chief Executive of the Exchange; and
- (5) the Secretary to the SFC (HKEC Listing) Committee and/or to the SFC (HKEC Listing) Appeals Committee, who shall exercise applicable powers and functions equivalent to those of the Secretary to the Listing Committee and/or Listing Appeals Committee.

38.06 The SFC (HKEC Listing) Committee shall consist of all Executive Directors of the Commission (except the Chairman of the Commission and the Executive Director in charge of the Corporate Finance Division) and an equal number of individuals (not being directors or employees of the Commission) with experience of the securities market in Hong Kong appointed by the Commission (each of the latter individuals being a “market representative”). The quorum necessary for the transaction of any business of the SFC (HKEC Listing) Committee shall be three individuals including at least one Executive Director of the Commission and one market representative. Any meeting of the SFC (HKEC Listing) Committee convened to review an earlier decision or ruling of the SFC (HKEC Listing) Committee (i.e., where the SFC (HKEC Listing) Committee is performing a role equivalent to that of the Listing (Review) Committee) shall consist of members who were not present at the meeting which made the earlier decision or ruling.

38.07 The SFC (HKEC Listing) Appeals Committee shall consist of the Chairman of the Commission and the nonexecutive Directors of the Commission. The quorum necessary for the transaction of any business of the SFC (HKEC Listing) Appeals Committee shall be the Chairman of the Commission and two nonexecutive Directors of the Commission or, in the absence of the Chairman of the Commission from Hong Kong, three nonexecutive Directors of the Commission.

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38.08 Each of the SFC (HKEC Listing) Committee and the SFC (HKEC Listing) Appeals Committee may elect any of its members to be chairman and may regulate its own procedures and business subject to any directions given to it by the Commission for this purpose. In so doing, each such committee may have regard to (but shall not be bound by) the practices and procedures of the Listing Committee or Listing Appeals Committee as set out in Chapters 2A and 2B, as the case may be. The Chairman of the Commission shall from time to time appoint a person or persons, who may be an employee or employees of the Commission, to act as Secretary of the SFC (HKEC Listing) Committee and/or SFC (HKEC Listing) Appeals Committee.

Rights and Obligations of HKEC as an Applicant for Listing and Listed Issuer

38.09 HKEC as an applicant for listing has all the rights and obligations that any other applicant for listing has, except that the Commission acts in the place of the Exchange.

38.10 HKEC as a listed issuer has all the rights and obligations that any other listed issuer has, except that the Commission acts in the place of the Exchange.

Rights and Obligations of the Commission

38.11 The Commission acting in the place of the Exchange has all the rights and obligations in relation to HKEC that the Exchange has in relation to any other applicant for listing or listed issuer.

Procedures Regarding Forms, Information and Documents

38.12 HKEC must complete any form, application or other document under the exchange listing rules that it gives to the Commission with any necessary adaptation including to reflect that the Commission is acting in the place of the Exchange.

38.13 Where the exchange listing rules require documents or information to be filed with or delivered to the Exchange, such documents

*Appendix 4: Chapter 38 of the Rules Governing the Listing of Securities
on the Stock Exchanges of Hong Kong Limited*

or information shall be filed with or delivered to both the Commission and the Exchange in accordance with any procedures issued by them respectively from time to time.

**The Commission's Role in Relation to Other Applicants
for Listing and Listed Issuers**

38.14 Conflicts of interest may arise between the Exchange and persons whom the Exchange regulates, including applicants for listing and listed issuers. Any person that considers a conflict of interest may exist or may come into existence, or may have existed and may continue or be repeated, between the interests of HKEC, the Exchange or any other company of which HKEC is the controller and the interests of the proper performance of any regulatory function performed by the Exchange should bring the facts of the matter to the attention of the Executive Director in-charge of the Corporate Finance Division of the Commission.

**The Commission's Powers and Functions
in the Event of a Conflict of Interest**

38.15 Pursuant to section 13 of the *Merger Ordinance* the Commission shall have those powers and functions in relation to conflicts of interests or potential conflicts of interest as are set out in this chapter and in the Memorandum of Understanding referred to in rule 38.02(2).

38.16 Where, pursuant to section 13 of the *Merger Ordinance* and this Chapter, the Commission exercises powers and functions with respect to other applicants for listing or listed issuers in place of the Exchange:

- (1) the provisions of rules 38.03, 38.04 and 38.09 to 38.13 shall apply as between the Commission and the Exchange and such applicant or issuer as if references to HKEC were replaced with references to the relevant applicant or issuer;
- (2) the Commission shall exercise such powers and functions through and within the framework described in rules 38.05 to 38.08.

APPENDIX 5: ***Procedures to Deal with Conflicts of Interest***

INTRODUCTION

1. Set out below are the procedures, powers and functions that will be adopted and/or exercised by the Securities and Futures Commission (SFC), Hong Kong Exchanges and Clearing Limited (HKEx) and/or The Stock Exchange of Hong Kong Limited (SEHK) with respect to conflicts of interest or potential conflicts of interest following HKEx's listing.

Definitions

2. For the purposes of these Procedures the following expressions shall have the following meanings:
 - Commission means the executive and nonexecutive directors, including the chairman, of the SFC appointed pursuant to section 5 of the *Securities and Futures Commission Ordinance* (Cap. 24) acting as a quorate body.
 - Conflict Committee Secretary means the Head, Listing Regulation and Risk Management from time to time of HKEx, or his or her equivalent. The Conflict Committee Secretary may not be a Committee Member.
 - Conflict Committee means a committee nominated by the Board of HKEx to consider conflicts of interest or potential conflicts of interest and comprising not less than 3 employees of HKEx (each a "Committee Member") provided that at least two Committee Members shall be Senior Executives. A meeting of the Conflict Committee may be effected by telephone or such other form of communication as the Committee Members may from time to time decide provided that all Committee Members participating in the meeting are able effectively to communicate with each other.

Appendix 5: Procedures to Deal with Conflicts of Interest

- Minimal Value means a sum equal to 3% of the most recently reported book value of net tangible assets of HKEx.
- Senior Executive means any of: (a) the Chief Executive of HKEx; (b) the Chief Operating Officer of HKEx; (c) the Chief Executive of SEHK; and (d) the Chief Executive of the Hong Kong Futures Exchange Limited.
- SFC Representatives means any one or more director, manager or other executive of the SFC from time to time nominated by the SFC for the purposes of these Procedures.
- In these Procedures, unless provided for above, where the context admits words and expressions the definitions of which are contained or referred to in the *Exchanges and Clearing Houses (Merger) Ordinance* shall be construed as having the meanings so attributed to them.

The Conflict Committee

3. HKEx shall use its best endeavours to ensure that staff within HKEx and companies of which it is the controller are alert to, and identify, conflicts of interest or potential conflicts of interest which may arise in the course of the performance of regulatory functions. All relevant facts giving rise to any significant conflict of interest or significant potential conflict of interest shall be brought to the attention of the Conflict Committee Secretary at the earliest possible opportunity. For these purposes, “significant” shall mean facts which a reasonable person would regard as giving rise to a conflict of interest or potential conflict of interest. A conflict of interest or potential conflict of interest involving any relevant contract, arrangement or other proposal which involves sums exceeding the Minimal Value shall always be referred to the Conflict Committee Secretary. The Conflict Committee Secretary shall convene a meeting of the Conflict Committee as soon as practicable after a conflict of interest or potential conflict of interest has been brought to his or her attention.
4. The Conflict Committee shall on such a referral consider the facts and determine whether a conflict of interest or potential conflict of

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interest does or may arise. It will then proceed as follows depending on the circumstances:

- 4.1 If the Conflict Committee determines that a conflict of interest or potential conflict of interest does not and will not arise in the circumstances, a brief written record of that determination will be made and placed on file.
- 4.2 If the Conflict Committee determines that a conflict of interest or potential conflict of interest does or may arise but considers that the matter can be resolved in a manner which assures the proper performance of any regulatory functions, it shall make written proposals to that effect to be considered in turn by the SFC.
- 4.3 If the Conflict Committee determines that a conflict of interest or potential conflict of interest does or may arise and considers that the matter cannot be resolved in a manner which assures the proper performance of any regulatory function, it shall notify the SFC accordingly which may then exercise the powers and functions set out at paragraph 11.

Resolution of Conflicts of Interest

5. Where the Conflict Committee has determined that a conflict of interest or potential conflict of interest does or may arise it shall notify the SFC Representatives of all relevant facts including any proposals for resolving the matter in a manner which assures the proper performance of any relevant regulatory function. The SFC Representatives shall then consider the circumstances of the case and determine whether in their opinion the regulatory function can be discharged without the intervention of the SFC. HKEx shall provide any further particulars that the SFC Representatives reasonably require.
6. If the SFC Representatives are satisfied that any proposal made by the Conflict Committee (incorporating, as applicable, any recom-

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mendation of the SFC Representatives) will assure the proper performance of any relevant regulatory functions, then HKEx shall implement such proposal, incorporating, as applicable, any such recommendation of the SFC Representatives.

7. If the SFC Representatives are not satisfied that action taken by HKEx (or a company of which it is the controller) will assure the proper performance of any relevant regulatory function then the SFC shall have the powers and functions provided pursuant to paragraph 11.

Appeal to the Commission

8. If the Conflict Committee disagrees in any respect with the approach taken by the SFC Representatives, the two parties will discuss the differences between them for a period of not more than 5 business days with a view to resolving their differences and reaching an agreed position as regards the conflict of interest or potential conflict of interest. On the expiry of such period if the differences have not been resolved the matter will be referred to the Commission and each of the Conflict Committee and the SFC Representatives shall prepare brief written statements of their respective views and the reasons for adopting those views for submission to the Commission.
9. The Commission shall within 5 business days of receiving such statements provide a written determination setting out (with reasons where applicable): (i) whether in its opinion the relevant facts do give rise to a conflict of interest or potential conflict of interest and, (ii) if so, the proposals, if any, it considers should be made for resolving the matter in a way which assures the proper performance of any relevant regulatory function in order to obviate the need for the SFC to intervene, or (iii) its conclusion that such intervention is unavoidable pursuant to paragraph 11 below.
10. The determination of the Commission shall be final and binding on all relevant parties. The Commission shall act as experts and not as arbitrators.

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The Role of the SFC

11. Where it has been determined or agreed in accordance with these Procedures that a conflict of interest or potential conflict of interest does or may exist, the SFC shall have the following powers and functions with respect to the performance of regulatory powers and functions by HKEx or any company of which it is the controller:
 - 11.1 the power to require HKEx to provide information with respect to its present and proposed interest and all those of any company of which HKEx is the controller;
 - 11.2 the power to give a direction to HKEx and/or any company of which it is the controller (and HKEx shall forthwith comply with such direction and procure compliance with such direction by any such company);
 - 11.3 the power to exercise all or any of the powers and functions of any company of which HKEx is the controller, and in such event the SFC shall have and be entitled to exercise such powers and functions to the exclusion of any such company.
12. Save in circumstances of mutual agreement prior to a determination by the Commission pursuant to paragraph 9, the SFC shall not exercise its powers and functions pursuant to paragraph 11 unless and until:
 - 12.1 the SFC Representatives notify HKEx in writing of: (i) the powers and functions the SFC intends to exercise and, (ii) the date on which such notice is to take effect; and
 - 12.2 HKEx has been given the opportunity to exercise its rights under paragraph 8.

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No Preferential Treatment

13. With effect from its listing and for so long as it is a listed issuer on the Stock Exchange of Hong Kong, HKEx shall not ask or require (or purport to ask or require) any company of which it is the controller to exercise regulatory powers or functions, take regulatory actions or make regulatory decisions which a reasonable person would regard as being intended either:
 - 13.1 to place HKEx (or any company of which it is the controller) in an advantageous position as compared with any person regulated by any such company; or
 - 13.2 to place any person regulated by any such company in a disadvantageous position as compared with HKEx (or any company of which it is the controller).
14. The prohibited behaviour in paragraph 13 shall be regarded as extending to persons with which HKEx (or any company of which it is the controller) has or proposes to have a business relationship or a person with which HKEx (or a company of which it is the controller) has entered into or proposes to enter into a business arrangement.
15. For the purposes of ensuring compliance with paragraphs 13 or 14, if the SFC has concerns at any time as to the proper performance of regulatory functions with respect to any particular person regulated by HKEx or companies of which it is the controller, the SFC shall be entitled to ask HKEx to provide reasonable particulars of any current and proposed business relationships and business arrangements between HKEx and companies of which it is the controller and that person and HKEx shall comply with such request as soon as reasonably practicable following receipt of such request.
16. HKEx shall procure that any company of which it is the controller shall take such actions, make such decisions and exercise such powers and functions in such a way as to avoid any occurrence as is contemplated in paragraphs 13 or 14.

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Cooperation Regarding Conflicts of Interest

17. HKEx shall procure that any company of which it is the controller shall comply with the provisions of these Procedures.
18. HKEx shall work with the SFC when the SFC has concerns regarding conflicts of interest, and shall implement any procedures which the SFC reasonably believes will enhance the operation of matters referred to in these Procedures.