

## **Remarks on the Penny Stock Incident at the OECD Roundtable**

Mr. Chairman, Ladies and Gentlemen, Good morning!

I am truly honored to appear here today with my other distinguished panelists to share in the discussion of the Penny Stock Incident. Before I begin, let me note that the views I express are my own and do not necessarily reflect those of the CSRC.

Since its occurrence, the Penny Stocks Incident and subsequent issues have drawn a lot of attention and led to discussions on the regulatory structure of Hong Kong's financial market and the listing matters in particular. The CSRC is very much concerned about the developments of the event and has been examining its own regulatory structure in a bid to prevent the occurrence of similar events. We hope that the Penny Stock Incident can be resolved appropriately and timely.

The Expert Group's Report, which contains in-depth analysis on the background and causes of the Incident, may serve as a vehicle in this regard. In particular, it has identified five inter-related issues: quality of market, conflict of interests, regulation of listed companies, regulation of intermediaries and role and responsibilities of the three tiers. All of them are vital regulatory issues for the securities regulatory authorities around the world. Chinese mainland stock market is also plagued by these issues, though the nature of problems may vary due to different social systems. In my remark today, I plan to give you a brief overview on the five issues with emphasis on their implications in Chinese Mainland market.

### **A. Quality of market**

Quality of market is identified as the origin of the Penny Stock Incident in the Report. The Report cites a lot of figures and facts to demonstrate that the quality of Hong Kong's Main Board and GEM is not that satisfactory, which, in turn, has aroused rising concerns about the valuation, liquidity, cost of capital and the international status of Hong Kong's financial market.

In terms of market quality, the Chinese domestic market has its own problems. Due to historical reasons, China's stock market was launched partly to raise fund for state-owned enterprises so as to reduce their debt levels. In the beginning, the listing requirement was based on a quota system, under which the CSRC allocated quotas to each province, limiting the number of companies eligible for listing. The quota, under the control of local governments, usually went to those mostly in need of cash, instead of those with reliable earnings records and sound financial positions. Therefore, the quality of listings was compromised in a sense. It was until the year 1999 that a market-oriented public offering review and approval system was implemented thus all enterprises meeting the listing requirements can apply for public offering. In addition,

the earnings quality of Chinese listed companies in general is unsatisfactory. Average earning per share, for example, was only RMB 0.149 in 2002 and ROE declined from 11.0% in 1995 to 6.0% in 2002. As at 2002, ?% of listed companies were in the red. Last but not least, the high P/E ratio of Chinese listed companies is also a matter of concern.

## **B. Conflict of interests**

The appropriateness of the HKEx as a listed company retaining its role as the primary regulator of companies seeking entry to the stock market and of their conduct after listing is questioned by the Report. “As a listed company motivated by profitability, the HKEx has a clear interest in listing as many companies as possible since listing fees represent a significant portion of revenues and there is a disincentive to allocate resources to enforcement which is costly and produces no revenue.” Therefore, the report recommends removing the listing function from the HKEx to the SFC.

Unlike the HKEx, Our Shanghai Stock Exchange and Shenzhen Stock Exchange are free from such conflict of interests, since the listing power rests with the CSRC at present. According to the *Securities Law* and *Measures on the Administration of Stock Exchanges*, stock exchanges in China are non-profit-making and self-regulatory legal entities. They are supervised by the CSRC, who also appoints their senior management personnel.

As an emerging market in transitional economy, the role of stock exchanges as self-regulating organizations is still weak because of the immature market mechanism. With improvements in the levels of regulation and supervision, the functions and interests between the CSRC and exchanges will be redefined and many regulatory and supervisory functions will gradually be transferred from the former to the latter.

## **C. Regulation of listed companies**

The Report has analyzed the problems in the regulation of listed companies, such as the multiplicity of corporate regulators, lack of investigative powers and limited enforcement ability or sanctions, listed companies’ being controlled by a small number of related shareholders and so on. The Expert Group believed that enforcement effectiveness would be enhanced if the listing function were to be taken up by the SFC.

In the area of listed company regulation, the problems faced by the CSRC are similar. To begin with, the CSRC is not the sole regulator of listed companies either. In China, State-owned Assets Supervision and Administration Commission of the State Council is in charge of the management of key state-owned enterprises. State Administration for Industry and Commerce is responsible for company registrations.

Secondly, the investigative powers of the CSRC are limited. For example, it cannot inspect the books of listed companies. Thirdly, about two-thirds of shares in our market are locked as state-owned or legal person shares and are non-floatable. As an ordinary resolution only needs half of the votes to be approved by the shareholder's meeting, and about half of the listed companies see their state ownership exceeds 50%, minority shareholders usually have little say in the operation of listed companies. Many boards are dominated by the controlling shareholders and their decision-makings lack transparency. Since the shareholding system has only been in China for just over a decade, the culture of shareholder value and the idea of protecting the interests of minority shareholders are yet to be embraced fully by the corporate world.

#### **D. Regulation of intermediaries**

In regard to the regulation of intermediaries, according to the Report, there have been considerable shortfalls in standards of due diligence in the case of sponsors, therefore, there needs to be more effective regulations on them and the threat of sanctions for misconduct must be real. I believe that these suggestions make good sense.

Regulation of intermediaries in the Mainland market is not flawless. In the wake of several high-profile corporate scandals featuring questionable practices and standards on the part of intermediaries, the CSRC has tightened regulations on underwriters, however, there remains much to be done in this area.

To weed out wrongdoing by underwriters and corporations, the CSRC introduced a de-merit system in September 2002, holding underwriters responsible for the well-being of companies they lead to listing. The underwriters would be penalized and see their deal quotas cut for six months if they accumulated 12 de-merit points within a year. The CSRC also issued a new regulation in October 2001, requesting companies applying for an IPO to undergo a one-year coaching period. The coaching institutions—securities companies—are responsible for educating the major shareholders and management of the listing candidates in the requirement for legal operations, fair information disclosure, internal control, clear corporate structure and proper responsibility for minority shareholders, etc.

#### **E. Roles and responsibilities of the three tiers**

The division of roles and responsibilities among three tiers, the government, the SFC and the HKEx is questioned by the Report. This is highlighted by the government's excessive involvement in the detail of regulation, the SFC's lack of true enforcement powers and the HKEx's confusing regulatory role.

In the Mainland, the promulgation of the *Securities Law* in December 1998

established China's securities regulatory regime with the CSRC as the sole regulatory authority under the State Council supervising the country's securities and futures markets, supported by self-disciplinary regulation by the stock exchanges and Securities Association of China. However, such a regulatory structure is facing similar problems to those in the Hong Kong market. For one thing, the CSRC, like the SFC, lacks true enforcement powers to fulfill its duties. On many things, such as the reduction of state-owned shares, the CSRC has to coordinate with other government authorities and consult their opinions. In addition, at present the regulation and supervision of the bond market is dispersed among a number of central government departments. Such a situation has restrained the developments of the bond market to a great extent. Finally, as I have mentioned in the part of "conflicts of interest", the role of self-regulatory organizations in the mainland is still weak because of the immature market mechanism. The CSRC is actually performing some of the duties of self-regulatory organizations and is too involved in their operations.

Apart from identifying problems, the Report has put forward a set of constructive recommendations, including transferring the listing function from the HKEx to the SFC, establishing a Listing Panel under the SFC as an advisory body on listing policies, strengthening the power of the SFC and providing it with more resources to perform its function as a regulator, and increasing the level of the cooperation between the SFC and the CSRC, etc. I believe that such recommendations are helpful and feasible.

It is perfectly true that any wholesale application of a regulatory model which works perfectly well in one jurisdiction may not be consistent with the particular interest of another jurisdiction. However, despite differences in our social system and regulatory environment, the Mainland market has a lot to learn from the Penny Stock Incident. It affords us valuable experiences in handling contingencies and prompts us to examine our own supervision and regulation framework. In this way, it is much easier for us to identify reform priorities.

In order to push forward reforms, opening up and steady developments of the capital market, at present and for a period ahead, emphasis should be put on the following aspects:

- (1) To consolidate the market infrastructure buildup and to perfect the legal system for capital market. We will cooperate actively and closely with the legislative bodies to accelerate the formulation and revision of related laws and regulations; at the same time, learn from international experience to improve the operational rules for capital market and the codes of conducts for market participants so as to build a clear, complete and multi-level system of professional conducts, and promote a culture of fiduciary duty in the market.
- (2) To reform public offering system further and carry out the sponsor system in a

bid to connect the performance of listed companies with the professional standards of relevant market intermediaries.

- (3) To strengthen supervision on listed companies, improve their quality, urge them to perfect corporate governance and enhance the truthfulness, accuracy and integrity of information disclosure in a timely and effective manner.
- (4) To improve the corporate governance, internal compliance and code of conducts of market intermediaries. We will open up the financing channel for securities intermediaries, effectively prevent and defuse financial risks and improve the overall quality and competitiveness of securities companies.
- (5) To reinforce and enhance the effectiveness of market surveillance, adjust our supervision strategy in accordance with specific conditions and remove any administrative review process, and to improve and perfect the functions of securities market. We will vigorously nurture institutional investors, link up the connection channels between money market and securities market, improve the stratum and products structures in order to meet the different needs of market participants and enhance capacities of the securities market in resource allocations.

Thank you!