

Hong Kong Institute of Directors Luncheon

“Corporate Governance”

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Good afternoon, Mr Herbert Hui
Ladies and Gentlemen,

I am delighted to have been invited to speak at this luncheon hosted by the Hong Kong Institute of Directors.

I am very pleased here today to speak to such a large audience of sophisticated and knowledgeable business people on the topic of corporate governance. But like most speeches delivered at the start of a year, it is customary to take stock of the past year and I would not wish to make an exception here.

Performance of the Hong Kong financial market in 2005

Financial market

Hong Kong’s financial market enjoyed a banner year in 2005.

As of December 2005, the total market capitalization of the Hong Kong market was HK\$8,113 billion an all-time high, while the turnover during the same period was HK\$4,498 billion. This figure surpassed the total turnover for the year of 2004¹.

Hong Kong continues to be one of the leading capital-raising centres in the world. 67 new listings were made on the Hong Kong Stock Exchange, raising a total of HK\$165 billion in 2005. For the year, total equity funds raised through primary and secondary fund raising exceeded HK\$294 billion. This puts Hong Kong again as one of the top five fund-raising markets in the world².

At the same time, Hong Kong has been able to keep an impressive track record as the primary fund-raising centre for Mainland China companies. Over half of the HK\$294 billion raised in the Hong Kong stock market in 2005 were raised by Mainland China companies or companies that have a significant Mainland operation³. This includes the mega listing of the China Construction Bank, which was reported to be the world’s largest IPO since 2001.

¹ Source: Hong Kong Exchanges and Clearing Limited (<http://www.hkex.com.hk>)

² Source: Hong Kong Exchanges and Clearing Limited (<http://www.hkex.com.hk>)

³ Source: Hong Kong Exchanges and Clearing Limited (<http://www.hkex.com.hk>). Provisional figures show the H-shares and Red Chips raised a total of HK76 billion in 2005.

Towards the end of 2005, the Hong Kong market saw the emergence of a new breed of investment products – Real Estates Investment Trusts (or REITs). Despite their new arrival to the Hong Kong market, REITs became an instant hit and three REITs of different property mix and investment strategies were listed raising a total of HK\$25.5 billion.

All the above facts and figures are impressive by any standards in terms of the capability of Hong Kong as an efficient capital-raising centre. But what I believe the business community here wishes to see does not stop here. What we would expect is that whether we can have a sustainable growth of Hong Kong from which long-term economic benefits can derive.

Key elements underpinning the growth of Hong Kong's capital market

Sustainable growth of a market cannot be developed overnight. As part of the community here, we all play a part in contributing to the success factors of this market - which I shall now touch on briefly.

While we may know very well where the strengths of this market lie, we may also wish to keep an open mind to criticisms and comments on the areas where the market can be improved – we cannot afford to be complacent - Hong Kong must not lose out in this increasingly competitive financial and business market both in Asia and on the world level.

Hong Kong's strengths are so much part of our daily work and life that we sometimes overlook their importance and may even take them for granted:

- Hong Kong has a fair and open market for all. Almost all international securities firms and investment banks are present in Hong Kong. Sophisticated and institutional investors have confidence investing in this market as can be seen in the record high daily turnover last week, which exceeded the HK\$40 billion level, the highest since the leading days of 1998 and the attack on the peg. Much of this can be attributed to the presence of a robust banking system with a free foreign exchange policy that encourages free fund flows and a free market that is able to realise the potential of full market economy.
- Hong Kong is a place that offers a reliable and transparent regulatory and legal system – the legal system here is well-founded and has proven to be dependable and fair. Parties contracting under the Hong Kong laws can have faith that our judicial system fairly and independently administers the law and that property rights of individuals and corporations are well protected. On the regulatory side, the Commission and other regulatory bodies believe in and uphold the principles of accountability, fairness and transparency to the market. While it is necessary to regulate the market in an orderly manner, it is not our objective to interfere with normal business operations or to overly regulate the market.

The strengths of the Hong Kong market make this place highly attractive to investors, be they domestic or foreign. Surges in recent market turnover to new highs since

1998 show that the global capital market has an abundance of liquidity. That said, such abundant liquidity is actually pursuing a finite number of investible choices, including stocks of good value.

Corporate governance

So how can a company enhance its value, and be able to capitalize on the global liquidity? While some people might think value enhancement is synonymous with the company being able to generate higher levels of profits each year, this may not be the only criterion on which to judge a company.

As can be seen in recent worldwide studies conducted on the competitiveness of markets and corporations, on a global level, investors attach huge importance to a market's and a company's corporate governance when it comes to assessing the value of a stock.

Given the time we have today, I would like to highlight just a few key observations drawn from these studies about the level of corporate governance in Hong Kong:

- According to the study of Asian Corporate Governance Association on 10 Asian markets in 2005, Hong Kong is in the leading position in the areas of enforcement. Hong Kong, however, had ranked slightly lower than Singapore in terms of corporate governance culture and international audit and accounting standards.
- In the study conducted by IMD in 2005, when comparing it in the Asian context, Hong Kong (8.00 and 7.40) has fared ahead of Singapore (7.62 and 6.39) in terms of auditing standards and credibility of managers in the economy.
- In the FTSE Institutional Shareholder Services (ISS) Corporate Governance index, the corporate governance rating of the companies listed on the Hang Seng Index was ranked 4th among the 24 markets studied by FTSE and ISS, and the top amongst Asia markets

While the above studies showed that Hong Kong is viewed by outsiders as a market with good corporate governance, the studies and ratings themselves are not a science; they are based on certain pre-selected criteria, which differ from one study to another, and influenced also by the perception of each institution which decides on the parameters of the studies.

What these studies did provide however is an indication of the areas of strengths and weaknesses (or the perception of them) for each market. For example, the studies commended Hong Kong on its enforcement regulation, but indicated that there is room for improvement on corporate governance culture, the political and regulatory environment.

Although the studies and rankings generally indicated that Hong Kong is a place of good corporate governance, we cannot be complacent with our ratings. As pointed out in some of the studies, one of the reasons for Hong Kong's and Singapore's high

rankings is due to the other markets' drop off in certain aspects of corporate governance. In order to maintain and enhance the corporate governance standards of Hong Kong, I think the market should not only expand on its existing advantages, but also should work on areas where outsiders perceive Hong Kong is at a less advantageous position than other markets.

Good corporate governance is both a concept and a practice that must be worked on by people in a company at all levels, it is the people inside a company that makes a vital difference between good and bad corporate governance. It is not about the company being able to tick the maximum number of boxes about attendance at Board meetings or disclosure of directors' pay.

No matter how many rules are laid down and how many procedures are adopted by a company for its corporate governance, it is the people who are in charge of the business operations who hold the key to good corporate governance. Noting from the studies perceptions of the need to further improve Hong Kong's corporate governance culture, I believe Hong Kong has the right people, such as directors like yourselves, to foster a better corporate governance culture.

Director's role in raising corporate governance

So what can the management of corporations do to put the concept of good corporate governance into practice?

Perhaps I am more privileged than some in the capital market to talk about the topic of corporate governance. During my stay in the London Stock Exchange, I was in the same position as some of the directors of listed corporations here in Hong Kong – I faced the challenge of having to deal with the constantly conflicting demands of enhancing corporate returns and the question of accountability on corporate governance. Here in the Securities and Futures Commission, I am on the other side of the table and have the privilege to keep an open dialogue with the market on how best to promote corporate governance.

With growing interests of institutional investors in the Asian market, rising corporate activism in this part of the world, and wider media interest in corporate activities, board of directors can no longer shut themselves off from the demands raised by various stakeholders. In order to deliver good corporate standards to their investors, directors are expected by the market and investors to be committed in the following:

- Accountability to stakeholders – directors should not hesitate to take up their responsibilities and discharge their functions dutifully. Sometimes, this means that executive and non-executive directors will have to think through and discuss matters that are important to the company and its stakeholders in an open and frank manner.
- Proper checks and balances – the Asian market has the unique trait of having a high proportion of companies that are family controlled or controlled by a majority holder. The board of directors should serve to the best interests of all stakeholders and not just a few. It follows that proper checks and balances such as the appointment of a good proportion of non-executive directors and

the conducting of independent audit on the operations of the company would help detect irregularities or abuses of powers within a company.

- Communication with stakeholders – I have seen in recent years in many blue chip companies an increasing focus on the importance of investor relations. We can see benefits derived from fostering the relationship between a company and a stakeholder. Most of the times, stakeholders are not actively monitoring or participating in corporate affairs. Sometimes discontented stakeholders might have been borne out of miscommunications rather than suspicious conduct of those managing the company. The most important aspect to investor communication is of course for a company to implement a proper disclosure policy so that price sensitive information is disseminated to the market in a fair and efficient manner. This goes a long way in building up the trust between the company and investors. Investors also get to know more about their company in order to appraise their investments in the company.

While there is no single magic formula to raise the corporate governance of every company, since different companies will require different processes due to their unique operational models, I believe there is one common but important element that all management should note in raising their company's corporate governance.

In addition to putting in place procedures and systems for corporate governance, directors have a more challenging task, that is to ensure that the corporate governance is effectively put in place and that staff at all levels, from the top to the bottom of the company, understand the need for good corporate governance and are involved in the process.

To make corporate governance culture pervasive throughout a company, it is key that the management communicates effectively to its staff the benefits of upholding good corporate ethics.

SFC's role in improving corporate governance

Raising Hong Kong's corporate governance profile will require efforts of all stakeholders in the market and each of us has a role to play.

For regulators, we are here to ensure the regulatory environment is conducive to good corporate governance. This is no easy task as we have to constantly maintain a delicate balance between regulation and facilitation of the market. And to us corporate governance is not just an issue that has to be addressed by listed companies, it is also a central theme for regulatory work that we have done on the enhancement of standards of intermediaries, which can be briefly divided into three areas of our current work:-

1. Reforms on the public offering of securities regime

Last year, we released a Consultation Paper on Reforms to the Prospectus Regime in the Companies Ordinance. The Consultation Paper aims to reform the regime governing the public offering of shares and debentures by a corporation. The proposals include proposed revisions to the Companies Ordinance to simplify and

increase the flexibility of the overall offering framework, and to the scope of liabilities attached to those involved in the preparation of securities offering documents.

It is intended that through such proposals, we can bring the regulatory regime over the public offering of securities in line with international standards.

2. Managing risks arising out of intermediaries business

The Commission also took various initiatives to raise the corporate governance standards through better regulation of intermediaries participating in the capital markets.

In terms of regulating conflicts of interests regarding sell-side intermediaries, we issued a set of guidelines governing the conduct of investment research analysts in early 2005. There are clear requirements in the guidelines that research analysts on listed securities have to ensure their views are independent of the influence of the companies that the research covers. The intention is that investors can get a more balanced and independent view on securities analysis whether for primary or secondary offerings.

In June 2005, the Commission consulted the market on a new licensing regime for sponsors with a view to enhancing the standards of sponsors in Hong Kong. So far, we have noted from the responses received that the market supports a tightening of the regulation on sponsors.

Meanwhile, the Commission continues to explore measures on how risks arising out of the repledging of clients' collateral in a broker may be reduced or mitigated through our continuing discussions with the market. We also are looking at related issues such as pooling risks and aggressive lending practices of securities brokers.

3. Enforcement

Besides the revision of regulations, the Commission also places emphasis on the enforcement of its regulatory regime, and is pleased to see that its efforts have been recognized, as evidenced by the results of the corporate governance studies mentioned above.

Market misconducts

Working jointly with other local enforcement agencies in Hong Kong, the Commission has recently assisted the ICAC in prosecuting a market misconduct case relating to market manipulation. The Commission will continue to work together with other local enforcement counterparts in cases involving market misconduct, corporate fraud and other market crimes.

Breaches of regulation by intermediaries and intermediaries-related conduct issue

The Commission also takes action against intermediaries who fail to comply with the relevant codes and regulations. Last year, the Commission took disciplinary action against an individual who was in breach of the analyst code of conduct, and against

intermediaries who failed to exercise proper supervision and insufficient internal controls, which as a result, led to regulation breaches by the staff of the intermediaries.

From January to November 2005, the Commission successfully prosecuted over 60 entities and carried out disciplinary action against 84 licensees. Having regard to the importance of surveillance and enforcement, Commission will continue to view this area a matter of priority in 2006.

But our approach to regulation is not just about enforcement. We place a great deal of emphasis on education and ensuring that the market and companies have access to information – most people want to know how to do things right – not how to break the law.

Annual IOSCO Conference in Hong Kong

Besides the Commission initiatives that I had just mentioned in the above, the Commission is also proud to be the host for the 2006 IOSCO Annual Conference. IOSCO is the international organisation that brings all the world securities regulators together. Delegates from all IOSCO member jurisdictions will gather in Hong Kong for one week to discuss the latest regulatory issues surrounding the global financial market. The Commission is currently making the necessary preparations for the Conference; and we believe that this will be a good opportunity for the world to experience first hand, the quality of the Hong Kong market and Hong Kong as a world-class city.

Conclusions

Looking ahead, I am sure that there are areas that we need to work hand in hand with the industry and business directors on how the level of corporate governance can be raised. Though I must say, Hong Kong has already ranked very much ahead of a lot of developed or emerging markets and I am confident that the Hong Kong market continues to score high on the league table of good corporate governance.

It has been a pleasure to share with you my observations and views on the issue of corporate governance, as well as giving you a glimpse of what's happening at the Commission this afternoon. I would like to wish you all a happy and prosperous 2006.