The Hong Kong Institute of Company Secretaries
Corporate Governance Conference 2006
"Corporate Governance – Time to take stock"
14 October 2006
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Good afternoon,

Ladies and Gentlemen,

I must start by thanking the Hong Kong Institute of Company Secretaries for inviting me to speak here today.

As usual, I should begin by saying that all opinion expressed here are my own and not necessarily those of the members of the Commission, its Directors or the members of the Commission's staff.

In the aftermath of the corporate scandals in the early 2000s, regulators around the world have instituted several major of corporate governance reforms to address the risks large corporate failure posed to a country's economy, and indeed the regional and global financial stability. Have these corporate governance rule changes made a difference?

A brief survey among Hong Kong companies indicates that many companies have reviewed their corporate governance practices in light of the Code on Corporate Governance Practices. The Code came into effect for financial years beginning 1 January 2005. The first batch of annual reports for financial periods beginning 1 January 2005 was published at the beginning of May this year. Initial review of these annual reports indicates that there is significantly greater disclosure on corporate governance practices with some companies disclosing details of how they implemented each provision in the Code on Corporate Governance Practices. The corporate governance report in the HKEx 2005 annual report is an exemplary model of a good report.

In the UK, where there has been more experience on how companies have implemented the revised Combined Code, which was introduced in 2003, a recent study on companies' corporate governance practices showed improvement in the quality of corporate governance practices as more companies were choosing to comply with the majority of the provisions. The dialogue between the board of directors and the companies' main shareholders was more constructive and that the overall quality of disclosure of annual reports had improved noticeably.

Who is responsible for improving corporate governance practices?

The directors

Most, if not everyone, would agree that a company's board of directors is responsible for the company's corporate practices as it is up to the board to decide and establish suitable corporate governance values and practices into its business model. It is generally accepted that the board of directors of a public listed company is the first and best line of defence against corporate fraud, especially abusive related party transactions.

Generally, the law does not distinguish between executive and non-executive directors –non-executive directors are subject to the same duties and obligations as executive directors. However, the expected standard of care is higher for executive directors who have a service contract with the company. Having said that there is a growing general expectation by market commentators that independent non-executive directors are appointed to the board to represent the minority shareholders. Market expectation of directors and particularly independent non-executive directors has risen. While it may have been possible for non-executive directors to argue in 1990s that they are only expected to do little more than attending a few board meetings, and perhaps some of the board committees that are established, such arguments are not likely to hold water today.

Various corporate governance codes around the world, such as the Combined Code on Corporate Governance in the UK and the Code of Corporate Governance Practices, emphasize the role and responsibilities of the non-executive directors, including the need for an independent board and independent non-executive directors. Independent non-executive directors are expected not only to participate in committees such as the audit, remuneration and nomination committees but also to form the majority in such committees.

The important role non-executive directors play is highlighted in Code Provision A.5.2 of Code on Corporate Governance Practices which provides that non-executive directors should participate in board meetings to:

- bring an independent view on issues of strategy, policy, performance, accountability, resources, key appointments and standards of conduct;
- scrutinise the company's performance in achieving agreed corporate goals and objectives; and
- monitor the reporting of performance.

Earlier this year in the U.S., the SEC took civil action against two directors and the Chief Finance Officer of Brocade Communications Systems on securities fraud charges. The U.S. Department of Justice brought criminal charges against the two directors for routinely backdating stock option grants to give employees favourably price options without recording necessary compensation expenses. The U.S. Department of Justice claims that by not properly accounting for the options expenses, the company's financial condition was misrepresented to investors.

On the home front, I have noticed that the most common reason cited for a director's resignation is "personal reasons". For instance, in two recent cases, two directors resigned citing "personal reasons" and failed to mention that one was jailed for a criminal offence[1] and the Insider Dealing Tribunal banned the other director from holding any directorships[2].

I have also noticed there appears to be a tendency for non-executive directors to resign just before the company announces that it may be facing financial difficulties or things generally turned south for the company. In times of crises independent directors should play a crucial role. We would expect independent directors to continue to act as directors at the time of crisis, however there maybe times when independent directors are prevented from fulfilling their duties and will have no choice but to resign. In such circumstances, directors should ensure that the reasons for their resignation fully explained to shareholders and the market. In a recent case, all the independent non-executive directors, and a number of executive directors, of a company resigned following or shortly before joint provisional liquidators were appointed. These directors cited "personal reasons" for their resignations but failed to explain the reasons for their resignations. The resignation of the independent non-executive directors left these companies without any non-executive directors.

Given the important role and function directors play, it begs the question whether directors should be allowed to resign when a company is liquidation or receivership. For instance, Rule 7 of the Codes on Takeovers and Mergers and Share Repurchases forbids directors of a company that is subject to a takeover offer to resign from the date an offer is made to the close of the offer. The main purpose behind preventing directors of the offeree company from resigning is to provide stability and to ensure that the directors remain in place to advise shareholders and to respond to the offer.

The intermediaries

The role market intermediaries played in some of the recent financial scandals underscore the important role they play. Sponsors play a pivotal role in the listing process because they are the main facilitator in bringing new listings to the market. Auditors audit financial statements of listed companies and ensure the integrity of the information presented. The recent corporate governance reforms have also targeted corporate reporting, especially the roles of the auditors and the audit committees, including oversight of the audit firms and auditing and accounting standards.

In January last year, ICEA Capital Ltd agreed to pay $30 million, without admission of guilt, to settle the SFC's disciplinary case against the sponsor. The SFC instituted disciplinary proceedings against ICEA for failure to exercise due skill, care and diligence in the course of performing its duties as sponsor for the listing of Euro-Asia Agricultural (Holdings) Co Ltd. Trading in Euro-Asia's shares was suspended a little more than a year after its listing in July 2001 amidst reports that it exaggerated its

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[1] Ngai Lik Industrial Holdings Limited's announcement dated 20 June 2006 regarding Mr Lam Ping Cheung, Andrew's resignation. Mr Lam was convicted and jailed for conspiracy to pervert the course of justice.

[2] Chinese Estates Holdings Limited announcement dated 27 January 2006 regarding Mr Wing Yee Koon's resignation. Mr Koon was disqualified from acting as a director or to take part in the management of a listed company for a period of 5 years.

earnings to qualify for listing and the arrest of its chairman by the Mainland authorities.

More recently, Ocean Grand Holdings Ltd's auditors discovered certain accounting irregularities earlier this year shortly before the company was liquidated. It is not axiomatic that a company is in financial difficulties when its auditors discover accounting irregularities, but cooking the books is a significant ingredient in the collapse of many companies, including Enron and Parmalat.

The SFC recently published the Sponsor Guidelines which is part of the Fit and Proper Guidelines. The Sponsor Guidelines will become effective on 1 January 2007. The SFC has also stepped up its efforts in inspecting sponsors' work in relation to listing applicants.

The regulators

When there is a corporate scandal or failure, the market often turns to the regulators saying that the regulators have failed or should have done more to detect or nip the matter in the bud.

Corporate scandals and failures are an inevitable fact of life and happen in all markets, be it London, New York or Hong Kong. The key challenge for the regulators today is implementation and enforcement.

The challenge of effective enforcement actions is particularly keen in Hong Kong where more than 80% of companies listed in Hong Kong are incorporated outside Hong Kong. Further, many, if not most, of the new listings in Hong Kong are Chinese enterprises or companies with substantial business operations in the Mainland.

The Companies Ordinance only applies to companies incorporated in Hong Kong. It does not apply to companies incorporated outside Hong Kong, except in so far these companies must have a registered office in Hong Kong and must comply with the prospectus registration requirements when offering shares and debentures for sale or subscription to the public. This poses a challenge to our regulatory framework on how to effectively regulate these companies – which are neither domestic nor overseas companies.

The main statutory securities regulation in Hong Kong is the Securities and Futures Ordinance (SFO). However, the SFC does not have any jurisdiction on corporate misconduct in any other country, including the Mainland. Our powers under the SFO are exercisable exclusively within the territorial limits of the Hong Kong SAR. The regulatory authorities can only effectively deal with breaches of the Companies Ordinance and the SFO if the company concerned is a Hong Kong incorporated company. Where the corporate misconduct occurs outside Hong Kong, investors will have to rely on the powers of the company's home regulator.

The main regulatory requirements for listed companies that are not incorporated in Hong Kong rests with the non-statutory Listing Rules administered by the Hong Kong Stock Exchange. However, these rules are only contractual in nature. In bid to strengthen regulation over listed companies, the Government, the SFC and the Exchange are working together to amend the SFO to give statutory backing to major listing requirements.

Co-operation with other regulators

There is a well-developed model under the International Organization of Securities Commissions, or more commonly known as IOSCO, where signatories to a Multilateral Memorandum of Understanding (MMOU) agree to share information and co-operate in cross border enforcement actions. Signatories to the MMOU can both seek and offer assistance to one another in investigating market misconduct and corporate failures. IOSCO's members comprise more than 100 regulatory agencies from around the world covering 90% of the world's capital markets, of which 30 are full signatories of the MMOU, including Hong Kong.

The Mainland securities regulator, the CSRC, is not yet a signatory to the MMOU. We have urged the CSRC to take the necessary steps to become a full signatory which would significantly enhance cross border regulation. Having said that the SFC enjoys the highest level of co-operation and assistance from the CSRC, and vice versa, under a regulatory co-operation agreement with the CSRC. The agreement does not cover all the areas of the IOSCO MMOU and is limited by the scope of powers currently granted to the CSRC in its governing legislation. However, this agreement is a key part of our ability to regulate Mainland companies. Through this agreement, the SFC and the CSRC meet regularly to discuss regulatory issues and policies and share public and non-public information with, and render regulatory assistance to, each other.

While there are differences between the Hong Kong and Mainland legal frameworks, both regulators have fully co-operated with each other as far as possible. The SFC will continue to work with the CSRC to strengthen our investigation and enforcement work relating to Mainland companies, and will liaise closely with them to understand how their new powers under the amended PRC Securities Law would enhance the regulatory assistance that they might offer to other regulators, including the SFC.

Investors

Investors and shareholders also have an important role to play in promoting good corporate governance. In principle, investors can pressure companies to adopt good or better corporate governance practices by supporting reforms and be more willing to engage management. Recent worldwide studies conducted on the competitiveness of markets and corporations show that investors, on a global level, attach huge importance to a market's and a company's corporate governance practices when it comes to assessing the value of a stock.

However, in practice most of Asia's investors are reluctant to get involved. They invest in a company if they believe that its growth prospects and risk premium outweighs all other factors and tend to sell their holdings rather than engage management when corporate governance problems arise.

Final words

To sum up, corporate governance reforms in Asia remain work in progress, although there seems to be improved disclosure. Responsibility for good corporate governance practice does not belong just to the regulators, but rather collectively to the directors, intermediaries and investors too. Having instituted regulatory reforms to promote good corporate governance, regulators must guard against complacency and strengthen enforcement efforts to improve standards. Directors are the vanguard of a corporate governance renaissance and need to wholeheartedly embrace the principles of good corporate governance practices. Intermediaries play a pivotal role in supporting companies' efforts to improve their corporate governance practices and ensuring the integrity of information. Investors must pro-actively demand for better corporate governance practices by exercising their rights at general meetings and not just vote with their feet or food. Thank you.