

## Hong Kong Corporate Landscape: Regulatory Issues? Hong Kong Institute of Chartered Secretaries Corporate Governance Conference 2014

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The purpose of my talk today is to describe what amounts to a new regulatory architecture for Hong Kong listed companies, which has nevertheless taken time to evolve. This new architecture involves some, but not many, new rules which are now all in place. It also involves some changes in the way we work at the Securities and Futures Commission (SFC).

Corporate governance is an incredibly vast field and it is clear that directors, company secretaries, advisors and even regulators are often confused by the topic. Governance standards come in many forms. There are multiple codes and rules often saying different things for different purposes. There are international rules issued by organisations such as the OECD, the International Corporate Governance Network, and the International Organization of Securities Commissions.

There are also local rules which are code-based and not legally binding. In Hong Kong they include the Stock Exchange's Corporate Governance Code. Then there are local rules which are "hard" law: those contained in the Companies Ordinance and the Securities and Futures Ordinance (SFO).

Not only are there multiple codes and rules, there are multiple regulators and authorities. In Hong Kong, the authorities that are either directly or indirectly involved in corporate governance include the SFC, the Stock Exchange, Companies Registry, Financial Reporting Council, Department of Justice, Commercial Crime Bureau and even the Independent Commission Against Corruption. And of course there are multiple stakeholders.

Overall, the framework is confusing and complex. This is further complicated by the fact that both the SFC and the Stock Exchange regulate the listed companies sector.

### **Oversight of listed company governance**

The regulatory architecture for Hong Kong listed companies should nevertheless provide a more comprehensive and straightforward regulatory framework for listed companies.

First, a common question: does the fact that both the Exchange and the SFC have oversight over listed company governance imply unnecessary overlap, duplication and inefficiency? My answer—as you may expect—is "no".

This is primarily because the Listing Rules promulgated and administered by the Stock Exchange are non-statutory. The rules are part of the SEHK's "platform brand" in the same way that other exchanges have different expectations of the companies that list on them. But



the Listing Rules also reflect the obligation of the Exchange to act in the public interest and therefore they are clearly extremely important.

The SFC is a statutory regulator, mainly operating and administering laws. Those laws are mainly contained in the SFO and the Companies Ordinance, and they are minimum requirements. The consequences of breaching them are dealt with only by courts and tribunals.

As a consequence, you can see that in fact there is no functional overlap between the oversight exercised by the Exchange and the SFC.

Another question: have there been gaps in the SFC's oversight of corporate conduct? Probably. There have been gaps in the past in relation to IPOs and in particular in the way we addressed the conduct of sponsors. There was also insufficient structure in the way in which we exercised oversight of the conduct of companies throughout their lifetimes as listed companies. In particular, I am referring to targeted detection of false disclosures to the market or concealment of information required by investors to make good investment decisions, as well as transfers of value at unfair prices to insiders and financial engineering to benefit insiders at the expense of investors.

### **The SFC's approach**

What are the factors that drive the SFC's strategy as a regulator of listed companies? Firstly, Hong Kong is a "host" jurisdiction for major areas of financial activity as well as a "host" for large financial institutions who operate within its markets. Its listing market is obviously a major host for companies based outside Hong Kong.

That gives Hong Kong unique opportunities and also implies unique vulnerabilities. Those vulnerabilities stem from the fact that, naturally, there are diverse corporate cultures overseas just as there are diverse governance traditions. Therefore we need to be hyper-vigilant in order to identify matters that can impact investors and our markets.

We are also aware of the discussion regarding class actions in Hong Kong. For some time, that has meant regulators have been relied upon to act as, effectively, a proxy for investors who are harmed by corporate misconduct, whether by taking action in the courts or otherwise, and that there is an expectation that regulators will continue to fulfil this role.

Our overall approach is:

- Better gatekeeping in relation to IPOs
- Better oversight of corporate conduct for companies that are listed
- To promote a level playing field for all companies, whether these companies are homegrown or whether they are overseas companies
- To ensure that well-governed companies can be confident that misconduct by others is likely to be detected and dealt with
- Ultimately it boils down to confident investors, quality markets, and lower overall cost of capital, which is a key practical outcome of good corporate governance



## **Regulatory architecture**

The purpose of the regulatory architecture now in place is to achieve much better clarity about the way we approach the listed companies sector as a statutory regulator. It consists of four components.

### *Gatekeeping*

In recent years, gatekeeping has been mainly about reforms taking place around IPO sponsors. We focused on making sure that the IPO process operates in a way that discriminates in favour of companies which present reliable and complete information at the time of IPO. We do our utmost to ensure that the system is geared to keep rotten apples out. This revolves around the due diligence which sponsors are expected to do, including public filing of complete prospectuses when filed.

One other element which did not get a great deal of publicity at the time these regulations were being adopted was that these changes also try to put more authority in the hands of sponsors. The goal is to enable sponsors to push back against companies which attempt to persuade sponsors not to look too hard at company information or probe too deeply by effectively playing different sponsors off one another in relation to such matters as allocating IPO shares.

In terms of sponsors' liability—which mainly involves false prospectuses and sponsors' potential involvement in them—we issued a very clear statement on 22 August 2014. In our view there is no doubt that when there is a false prospectus, sponsors are potentially liable both criminally and civilly under the current Companies Ordinance. We also said we would not hesitate to take action in suitable cases. It is also important to note that sponsor liability is in no way a proxy or substitute for director liability. They are separate and one does not supplant the other.

### *Disclosure of information*

The second component of the regulatory system is statutory backing of the obligations to make proper “real time” disclosure throughout the life of the listed company. The continuous disclosure requirements in the SFO took effect on 1 January 2013, breaches of which amount to market misconduct. From our perspective this has led to some quite big changes in behaviour.

### *Corporate Regulation Team*

Thirdly, and very importantly, we are developing for better real-time oversight of listed companies' conduct. A new Corporate Regulation Team located in the SFC's Corporate Finance Division has been established as a proactive and dedicated group to oversee the listed sector. The team covers companies from their births (IPOs), through their lives, and sometimes also handles their “deaths” (in the event of delisting). The team's focus is on conducting very careful reviews of corporate information and disclosures to detect problems and follow up on red flags.

The Corporate Regulation Team's work does not overlap with the work of the Stock Exchange because it is not looking at Listing Rules, but rather at broader issues. For example, it looks at potential problems to do with related party transactions that may be unfair. That is not necessarily confined to transactions falling within the definition of connected transactions within the Listing Rules. It could lead to companies being sent



compliance letters articulating our expectations, or it could lead to referrals to our Enforcement Division. The team has now issued the first bulletin about its work and more bulletins will be published in the future. These bulletins are meant to be informative, to encourage discussion and awareness and to provide some guidance around what we think are best practices arising out of the team's themed work.

### *Enforcement*

The fourth component is a very clear and well-communicated enforcement policy. We have a very firm two-pronged strategy underpinning action to address serious governance failures—punitive and remedial; the SFO allows us to investigate and pursue a range of criminal and civil actions. And our Corporate Regulation Team now enhances our ability to detect misconduct which could lead to enforcement cases.

The venues where we pursue cases include the civil courts, criminal courts, and the Market Misconduct Tribunal (MMT). The specific enforcement tools we have are scattered across the SFO. The important ones are:

- Section 179: The threshold to launch an investigation has been set at a practical threshold, and include circumstances ranging from fraud to circumstances where shareholders have not been given all the information they may reasonably expect.
- Section 384: This is a criminal provision concerning intentional or reckless provision of false or misleading information to the SFC or the Stock Exchange.
- Section 213: In the summer of 2013, the Court of Final Appeal (CFA) in the Tiger Asia case made absolutely clear that this remedy is separate from other proceedings and self-standing. We do not have to go to the criminal courts, MMT or anywhere else to get a ruling on a contravention either of the SFO or the Companies Ordinance before we go to the court to seek Section 213 orders. This means that we are able to seek a range of orders to seek remedies for those harmed by misconduct and freeze assets very quickly when needed.
- Section 214: Civil remedies which deal with a host of matters, including unfair prejudice to shareholders, oppression, fraud, and again, failure to give information to shareholders which they may reasonably expect to have.

When we go to civil courts the orders which are available to us are very wide ranging—from asset freezing and derivative actions to winding up and disqualification. Ultimately, given we have open markets and, effectively, open borders, one of our primary goals when there is wrongdoing is to be able to isolate assets in order to remediate the harm done. We also pursue punitive outcomes which have a clear deterrent effect.

### **Examples of corporate failures**

In the last few months themes arising in the misconduct cases we have looked at included false accounts (false financial information or representations on the part of management); self-enrichment of insiders (breach of directors' duties); and disclosure of false information to the market or concealment of information from shareholders.



#### *False accounts/overstatement of financial position*

- Greencool Technology Holdings Limited

In June 2014, we launched proceedings against the former Chairman and other senior executives of Greencool for gross overstatement of financial accounts. That action followed a seven-year investigation across multiple jurisdictions. We used Section 213 to freeze assets of \$1.59 billion, seeking compensation for around 1,300 minority shareholders.

- Qunxing Paper Holdings Company Limited

In December 2013, we made allegations against Qunxing Paper involving a false prospectus and exaggerated turnover. We obtained a freezing order for assets up to \$2 billion and sought orders under Section 213 for contraventions of the SFO and the Companies Ordinance. Later we appointed a receiver over the company.

- China Metal Recycling (Holdings) Limited

In July 2013, a case was launched in respect of China Metal Recycling's overstated financial position in its IPO prospectus and annual reports. Because the situation was urgent and serious, we immediately sought a winding up petition under the SFO to protect shareholders and creditors.

#### *Breach of directors' duties*

- GOME Electrical Appliances Holding Limited

The GOME case in March 2014 involved an allegation that share repurchases were arranged by the former Chairman to repay a personal loan. This case was resolved through agreement by the Chairman to pay \$420 million in compensation to GOME, equivalent to his gain and the loss to the company.

#### *Disclosure of false or misleading information (or concealment)*

- CITIC Limited

The CITIC case alleges disclosure of false or misleading information following massive losses on leveraged forex contracts. We have asked the MMT to consider potential sanctions against CITIC and five former directors and we are invoking Section 213 to seek compensation for investors who bought shares whilst the market was misinformed.

#### **Achieving better outcomes**

The overall regulatory framework now in place aims at enhancing confidence in Hong Kong's capital markets through firm action without excessive rule making. Our approach is by and large only to introduce a new rule or law when it is really essential. What we do is deploy the tools we have as effectively as possible.

This is a comprehensive, structured approach easily understandable by directors, company secretaries, and other market participants. We will also continue to produce bulletins to provide more guidance. The goal is to help the industry towards better outcomes and to avoid situations which merit more serious, individual regulatory action.



Our focus is primarily on more effective detection and enforcement of the law as it now stands. We will focus on the serious end of misconduct which harms investors and markets; we do not enforce the Listing Rules and associated governance codes. But of course compliance with them (which are enforced by the Stock Exchange) does reduce the risks of companies ending up on the wrong end of regulatory action by us as statutory regulator. Ultimately it's all about better outcomes for companies, investors and markets.