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What Does Investor Protection Mean in Hong Kong?

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In the last few months there has been some debate in the press about investor protection in Hong Kong, particularly protection for small investors and minority investors.

This is a particularly suitable forum for me to express some of my thoughts on this subject.

First, it is necessary to address what is meant by investor protection. This has many aspects. I will briefly review the main ones.

First, there is protection against loss due to financial defaults by market participants. This is perhaps the most fundamental area of investor protection and it tends to be taken for granted when market mechanisms are working effectively, as they are now (but were not as recently as 1987). In this context the key protection is an effective central clearing and settlement system with proper risk management procedures consistently applied. This we now have in CCASS, the central clearing and settlement system, whose establishment was a key milestone in the development of Hong Kong's equity market. To back this up, and to provide protection for investors in securities trading activities outside the exchanges, there are rules about the capital resources which authorized dealers must have. Observance of these is controlled by the Stock Exchange of Hong Kong (Stock Exchange) and the Securities and Futures Commission (SFC) and is currently working well. Beyond this, there exists in the Stock Exchange a well-

endowed compensation fund to compensate investors in the event of broker defaults, and a compulsory brokers insurance policy which (among other things) protects investors from loss or theft of securities or cash by Members' staff or agents.

The *second* main area of investor protection is protection against abuse by financial intermediaries (brokers, dealers, investment advisers - dare I say it, the sort of firms whom most of you represent). The main protections in this field are:

- The licensing procedure for brokers, dealers and investment advisers, with its "fit and proper" criteria, administered by the SFC, and by the Stock Exchange in relation to our own members.
- Conduct of business rules, applied by both the SFC and the Stock Exchange, designed to ensure that abusive practices (such as front running and rat trading) are prevented.
- Regular inspections (such as those carried out by the Stock Exchange of our members) to check compliance with financial resources and business conduct rules.
- Disciplinary procedures in the case of rule breaches.

A related protection against abuse by financial intermediaries is the transparency of the trading system. Since the introduction of auto-matching (AMS) by the Stock Exchange in 1993 there is a high level of transparency and objectivity in the pricing and prioritization of orders.

In all these areas, I also think it is fair to claim that Hong Kong's investor protection systems are now working reasonably well.

I now come to the *third* area of investor protection - protection against abuse by other shareholders, particularly controlling shareholders, and by company directors and managements. This is the field around which recent debate has mainly centered and where everything in Hong Kong's garden may not be so lovely. So it is this area I would mainly like to talk about.

One of the reasons this is a perennial theme in Hong Kong is that the shareholding structure of most Hong Kong listed companies is different from that of most listed companies today in markets such

as the US or UK - in that Hong Kong listed companies are more often than not controlled by an individual or family who originally built them up. The temptation is obvious for such controllers to use their controlling position, and sometimes their superior knowledge of the prospects of the business, to increase their wealth at the expense of other shareholders. Hong Kong's corporate history has many examples of deals or company restructurings which have had this effect. On the other side, we should not forget that in the case of a majority of Hong Kong listed companies, controllers have generally acted with exemplary fairness.

To some extent, the weakness of smaller shareholders relative to company controllers is a product of Hong Kong's social and business culture and history more generally, particularly a widespread and healthy belief in the principle of *caveat emptor* (Let the Buyer Beware) - the belief that investors are grown up people and should look after their own interests without Nanny (in the form of Government or the Stock Exchange) needing to intervene to bail them out. This prevailing business culture has undoubtedly influenced the development and content of rules, regulations and legislation designed to protect smaller or minority shareholders. In the area of legislation in particular (to which I will return later) there are fewer provisions designed to protect minority shareholders than would be found in most international markets.

But before trying to reach conclusions, I would like to examine briefly what protections do currently exist in Hong Kong. The main relevant instruments are:

- The Listing Rules of the Stock Exchange
- The Companies Ordinance
- The Securities and Futures Commission Ordinance
- The Securities (Disclosure of Interests) Ordinance
- The Securities (Insider Dealing) Ordinance
- The Code on Takeovers and Mergers
- The Code on Share Repurchases

I would like to examine some of these. First the Stock Exchange Listing Rules. As you know, since 1991 the Exchange has had (on a delegated basis from SFC) the role of front-line regulator of listing matters. The Listing Rules are designed primarily to ensure that:

- Applicants are suitable for listing;
- The issue and marketing of securities is conducted in a fair and orderly manner and that potential investors are given sufficient information to enable them to make a properly informed assessment of an issuer;
- Investors are kept properly informed by listed companies of factors, developments or transactions which might affect their interests - in particular, that immediate disclosure is made of any information which might materially affect the price of a company's shares;
- All holders of listed securities are treated fairly and equally; and
- Directors of listed companies act in the interest of shareholders as a whole, particularly where public shareholders represent the minority.

Of particular importance in the context of minority shareholder protection are the Notification provisions in Chapter 14 of the Listing Rules which require notification to shareholders of transactions of a certain type or size, and consent from shareholders for certain transactions, notably most 'connected transactions' - i.e. transactions between a company on the one hand and a director, substantial shareholder or chief executive (and any associates) on the other. In such cases there is obviously particular scope for conflicts of interest.

Also important are the financial disclosure provisions of the Listing Rules and the accounting standards attached to these.

As you know, back in 1989 our Listing Rules were re-drafted, based on those of the London Stock Exchange. They have subsequently undergone a series of amendments. I think it is fair to claim that they are fully in line with international standards. Of equal importance to the actual rules is ensuring that they are understood and accepted.

This means "education" of listed companies and other market practitioners (such as merchant banks) in their responsibilities towards investors. I do not wish to make it sound as if the Stock Exchange is "teacher" and the listed company directors are all school boys. Nor do I (*pace* Mr Ermanno Pascutto) advocate examinations (indeed, I understand Mr Pascutto never actually proposed exams either). But there is a great deal the Stock Exchange can do and is doing to influence corporate and market behaviour towards respect for the rules (which is really enlightened self-interest in the long term) and to develop a more investor-protection-conscious culture. Our Listing Division organises regular workshops on corporate governance and investor protection issues. I know the Division has plans to expand these activities.

There is, however, one area where it is arguable that the Exchange needs more backing, which could only come through Government action. This is the area of enforcement. The Listing Rules form the basis only for a contractual agreement between the company and the Stock Exchange. The sanctions which can be applied by the Exchange if the Rules are breached are confined to reprimanding or (in extreme cases) censuring a company or its directors, declaring persons unfit to be directors of a listed company and, as a last resort, suspending or canceling the listing. Reprimand and censure may be effective as a deterrent to some (generally the respectable) members of the community, but the inconvenience they cause to unscrupulous businessmen is unfortunately limited. And reprimanding directors does nothing to compensate investors who have lost money. Suspension or cancellation of listing is often a self-defeating weapon in the context of protecting minority shareholders, since it removes from them the market - the only means they have of getting out. Thus, in the context of enforcement, the Listing Rules by themselves can only go a limited part of the way.

In most other "developed" markets, where the Stock Exchange is the primary regulator of listing matters, there now exists statutory backing for the Exchange's listing rules. Such backing was introduced

for the London rules by the UK Financial Services Act of 1986. In other markets, there are provisions in statute which impose obligations on listed companies and their directors which parallel our principal listing rules, breaches of which carry statutory penalties and/or an obligation to compensate investors. I do believe the time has come where Hong Kong should seriously consider whether we need something similar in our own legislation. I would like to put this idea up for serious public discussion. If we do introduce legislation in this area, I believe it should be simple and limited in scope to providing a few statutory "teeth" to support the Listing Rules. This would not in any way reduce the role of the Stock Exchange. Indeed, it should reinforce that role. Nor do I believe it would be any inconvenience to the vast majority of company directors, to whom correct behaviour is a matter of course. It should, however, influence the behaviour of the small minority who are tempted to flout the rules. If such statutory obligations for listed company directors are introduced, they should be applied pragmatically and accompanied by informational programmes run by the Stock Exchange or SFC, designed to make sure that such directors are fully aware of their obligations.

Apart from the Listing Rules, what other protections for smaller investors are there? The Companies Ordinance contains important provisions concerning fraud and misfeasance by directors, but this piece of legislation is a framework for company formation and control in general and does not attempt to deal with the particular requirements relevant to listed companies. Company law and securities law are different things. Moreover, something like half the listed companies in Hong Kong are incorporated outside the territory, and are thus not in any case subject to many of the provisions of the Companies Ordinance.

The SFC Ordinance and Securities Ordinance are relevant in that they give to the SFC certain powers of investigation. However, these are basically confined to matters related to dealings in securities, rather than the behaviour of company controllers or managers. If

there is a *prima facie* case of fraud, the SFC or the Government may intervene, but oppression of minorities does not fall into this category.

The Securities (Disclosure of Interests) Ordinance (commonly referred to as the SDI Ordinance), addresses disclosure of shareholdings of directors, chief executives and their associates and of other so-called "substantial shareholders" with holdings above a certain size, and increases or decreases in such shareholdings. It is a complex and rather turgid piece of legislation and the disclosure threshold (10%) for substantial shareholders is too high to be meaningful in many situations. I understand consideration is being given to lowering this. In the UK the threshold is 3%. However, as regards disclosure of share transactions by directors and others, the SDI Ordinance has been quite successful - and a number of disciplinary actions have been taken by the Exchange and the SFC stemming from SDI disclosures or (perhaps more accurately) non-disclosures. Incidentally, the application of the SDI Ordinance, when it was first introduced, was a good example of what I call "pragmatic" application of a statute. Attention was given to education, and for an initial period the provisions were applied leniently while the market adapted to the new provisions. A similar approach should be applied if Hong Kong decides to adopt any new statutory obligations for listed company directors.

The Insider Dealing Ordinance was introduced in 1990. It was based on an earlier piece of legislation specially designed for Hong Kong which also operated through a specially-established Tribunal. Prior to 1990, the strongest sanction for insider dealing was public censure. Now, the penalties include fines of up to three times the profit illicitly made or the loss avoided. The Tribunal is by nature a somewhat unwieldy instrument and the number of cases it has handled (or could handle at once) is very limited.

Tackling insider trading is notoriously difficult in any market and provides enough debating material for a speech by itself. In most international markets it is now a criminal offence. This has not meant that insider dealers have been caught or successfully prosecuted in many cases. Leading international opinion is, I think, trending now

in favour of strong civil penalties as being the most effective sanction, sometimes together with a right of legal action against the insider for those disadvantaged by his trading. Hong Kong not only has no criminal penalties, but the civil penalties which exist are "softer" than those in almost any other market which seeks to call itself international. I believe this is a matter which deserves to be considered again by Government in the light of experience in the last few years and international developments.

Another important instrument in the context of maintaining equal treatment between shareholders is the Takeover Code. Hong Kong's Takeover Code is modelled on the UK Code and is administered by the SFC. It applies also to many corporate restructurings which may not strictly speaking be takeovers or mergers. In many cases covered by the Code, issues of fair treatment for minorities also arise. Like the UK Code, it is "voluntary" (i.e. it lacks statutory backing), and the ultimate sanction against a party who flouts the Code is public censure or the so-called "cold shoulder" rule (requiring merchant bankers or other professional advisers not to assist the party concerned in future). The effectiveness of these sanctions in a UK context is greater than in Hong Kong. In most other jurisdictions, takeover matters are governed by legislation. Thus, in this area also, Hong Kong is at the "soft" end of the international regulatory spectrum. Although the Code has worked (in my view) surprisingly well in recent years, I believe the time has come when Hong Kong should perhaps consider a simple provision giving the Code at least some statutory backing in the enforcement context. At present the Code has no real teeth when faced with an abuser of minorities who does not care about his reputation in Hong Kong and will not need the future support of Hong Kong's professional advisers.

What other provisions exist in Hong Kong to help smaller shareholders? I would like to mention the Model Code for securities dealings maintained by the Stock Exchange which lays down minimum standards of good practice for directors of listed companies in relation to their personal dealings. Also important are the provisions of the

Listing Rules concerning corporate governance - in particular the requirement to have at least two independent non-executive directors. Such directors can act to some extent as a watchdog over company managements or controllers; at least they can play a key role in relation to connected transactions.

The quality and timeliness of financial disclosure is of course one of the most vital weapons in protecting against abuse of investors. This was one of the areas of particular focus when the special listing framework for "H" shares was developed. So far, the rules in this field have worked better than I think many people expected. But, whether the listed company is based in PRC, Bermuda or Hong Kong, the effectiveness of the enforcement measures available remains an issue.

So, what more can be done to improve the investor protection framework in Hong Kong? One suggestion made by Mr Anthony Neoh was that institutional fund managers (including no doubt, many of the firms you represent) should adopt a more pro-active stance on behalf of small investors generally. I support this. But I do not see it as more than a very small part of what is needed. Institutional shareholders in Hong Kong do not (even collectively) hold anything like the percentage of most Hong Kong listed companies that their counterparts in the UK would own. And it remains a sad fact that retail investors in Hong Kong (as in many other places) generally do not consider it worth devoting time and money to fighting for their rights in cases where they feel abused. Part of the reason for this may well be the absence of statutory provisions which would give minority shareholders (whether institutional or retail) a basis for pursuing legal action against company managers or controllers. At present, the most they can generally do is try to mobilise public opinion, or rely on the regulators (whose powers, as I have already noted, are also limited). The efficacy of public opinion in Hong Kong against individuals with large and entrenched financial interests at stake has to be questioned.

I therefore believe that the time has come when we should consider whether some basic new legislative provisions are required. I do not think they would need to be extensive or complicated.

Anything we introduce certainly should *not* be modelled on US legislation, which is voluminous and onerous, and has inevitably generated more litigation than is healthy. The issue, I believe, is whether Hong Kong should introduce one or two basic statutory obligations for directors of listed companies, such as an obligation to make disclosure of facts or events which are clearly material to the value of the company's shares, and to give a true and fair picture in all such public announcements. If we decide from a policy point of view that such provisions are appropriate, the opportunity could be taken to include them in the rationalization of securities legislation which is, I believe, due to emerge from the SFC or Government before too long. As I mentioned before, any such provisions should be applied flexibly and pragmatically, and should be accompanied by a special "educational" programme for both directors and investors.

I am, of course, all too well aware of the problems associated with enacting new legislation at this time. Comments have been made by some regulators that politically it is difficult to get the law changed. But it is also difficult to accept that Hong Kong should remain motionless in an area which is important to our credibility as a mature financial centre. I think it is widely accepted that several aspects of our securities legislation need to catch up with the growth which has taken place in our market and the more sophisticated and international environment in which we are now operating. I believe it is in the interests of China as well as Hong Kong that this issue should be addressed.

Governments have many preoccupations, particularly in Hong Kong at this time. The old principle that you do not mend something until it has broken down is always a powerful force in favour of leaving things as they are. Nor could I claim that the legislative weaknesses I have mentioned in our investor protection framework are of such a nature as to lead to sudden and dramatic collapse of the market. But the effect of not addressing these issues could over time become a debilitating factor in the international competitiveness of our securities market.

While suggesting that these matters should be considered, I would still like to reaffirm my general belief that Hong Kong is right in its philosophy that regulation should be kept to the minimum which is really necessary to preserve the status and development of our market, and above all that the rules should be kept simple. I am as sensitive as anyone else in the business community to the dangers of over-regulation. But I do believe that, where we have regulations, they should be capable of effective enforcement. And I believe we should not deceive ourselves into thinking we have effective regulation just because we have the rules. They need to be backed up by the knowledge that if they are flouted, life could be seriously unpleasant for the flouter. This is the area in which I would like to see a serious review by Government of whether some legislative changes should, despite the possible difficulties, be introduced.