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**The standard of governance required of listed companies and the role the SFC plays
in stamping out corporate corruption and management misconduct**

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Good afternoon, Mr Chairman, ladies and gentlemen,

Thank you for inviting me to speak at the Symposium.

I would like to talk to you about the standard of governance required of listed companies and the SFC's role in stamping out corporate corruption and management misconduct.

With a market capitalisation of US\$140 billion, Hong Kong is the world's eighth largest stock market and the second largest Asian market after Japan.

Each day seems to bring new records or stock market surges not just in Hong Kong but globally. Here we see unprecedented volumes of trading. The index has smashed through the 17,000 barrier. Globally markets are at 5-year highs. And I read in the press that Hong Kong will next month see the world's largest IPO for 6 years!

Now ... with all the euphoria about markets – it is easy to forget the fundamental purpose of a stock market. Its role is actually very simple – it provides a mechanism to allocate capital to ideas. Companies – sometimes very large state controlled companies; sometimes small entrepreneurs – want capital. Sometimes this is to develop new products or business lines; sometimes it is to acquire other businesses which they think they can run better. Sometimes it is replacement capital for money already spent. But essentially the need is very simple – capital.

Investors on the other hand have capital – what they want is a return on their money. They are prepared to take a risk in doing this. If they take a lot of risk – such as investing in a start up or some hi-tech business – they expect a lot of return. There is of course the down side risk that they lose what they have invested – but investors are generally optimists so they tend to focus on the upside potential.

So that is essentially what a market is about. Channelling capital from people with money who are prepared to take some risk to get a return – to ideas.

From the point of view of the company there is of course a cost – in return for the capital you give up control. Ultimately you may give up all control – the management of the company are effectively employees, with the prime focus of generating return for the people also have invested. In some cases it is only partial control – here the original shareholders want to retain some but not overall control of the company. In some cases the original shareholders retain control – they allow minority shareholders to invest – but

still effectively control the company through their majority position. This is where it gets really complicated – who looks out for the minorities? If they don't like what's happening in the company they can't sack the management!

I said earlier that shareholders basically invest for a financial profit. That's true – but not all shareholders act in the same way. Many – probably most – invest because they think the management of the company will do a good job. They can sit back and relax and watch the value of the investment grow – that's the easy bit if you pick the right company. Some, however, invest because they really want to exert control – to force the management to act differently, maybe kick out the CEO or change the strategy of the company – or even take over the company. That's a lot more aggressive than just sitting back and watching value grow – but ideally the outcome is the same – better returns.

In an ideal world the company does what it says it will. It invests in the strategies that it said it would – it looks after its assets carefully – and it politely asks its shareholders for permission to do anything different. But ideal worlds only ever exist on paper.

The reality is that investors give over a lot of money to companies. Some of those investors are very big and do a lot of homework first – many don't. Particularly private investors – who will give their money over to people they have never met; to follow strategies they do not understand – and whose detailed financial statements they have never opened. They will do so because the company is “hot” so its share price is bound to go up. I was once told that in reality there were only 2 types of investors – forget the distinction about Hedge Funds, private investors, macro funds, arbitrage funds etc – all investors fall into one of two categories – those who are insiders (i.e. they have privileged information not available to all) and those who think they are insiders.

Our job as a regulator is to try to ensure that the capital allocation process – so important to every economy – operates in a fair and efficient manner. To stamp out insider trading, and to ensure that investors rights are protected – no regulation is designed to ensure that an investment is profitable – you might simply pick the wrong company. But an investor should have the confidence that the company will operate according to the prevailing laws, codes or guidelines.

What I would like to do today is provide a little background on the regulatory structure in Hong Kong – both what exists today and how that structure is developing. I will describe the enforcement philosophy of the SFC in Hong Kong – what we do and how well we do it. And I would like to spend a little time on the thorny issue of extraterritorial jurisdiction – what do you do when you want to enforce across borders. This is a particular issue for Hong Kong which I shall explain later. Mr Deng Xiaoping coined the phrase “one country, two systems” to describe the return of Hong Kong to Mainland China. And that is exactly what we have got – two legal systems for one country which brings its own complex issues.

The Hong Kong stock market is unique in many ways. Compared to other major world markets, a significant proportion of Hong Kong listed companies are controlled by a major controlling shareholder, be it the founder, founding family or, in the case of Mainland companies, a state-controlled entity. This itself is unusual but means that as a regulator we must pay a lot of attention to the interests of minority shareholders. More than 80% of the Hong Kong listed companies 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. Mainland companies seek listings in Hong Kong for capital – but also because of its sound legal and regulatory framework, free flow of capital and information and, a critical mass of professionals and service-providers that adopt practices which are of international standards.

The regulatory framework governing listed companies in Hong Kong can be divided into:

- a. Corporate law and regulations – e.g. the Companies Ordinance, a company's constitutional documents, the Listing Rules;
- b. Securities law and regulations – the Securities and Futures Ordinance (SFO); and
- c. Industry or market standards of practices – e.g. accounting and auditing standards.

The main statutory securities regulation in Hong Kong is the SFO. There are three levels of sanctions against listed companies and their directors under the SFO. Firstly there is the criminal law. The SFO creates a number of offences which the SFC may prosecute in the Magistrates' Court. These range from disclosure of interests breaches to unlicensed dealing or advising, and from cold calling to market manipulation. Although most successful prosecutions result in a fine, custodial sentences have been imposed for market manipulation. More serious forms of such offences would be referred to the Commercial Crime Bureau with a view to prosecution on indictment by the Department of Justice.

The second is civil action before the courts. The SFC has significant intervention powers in Part X of the SFO to enable it to go to court to seek among other things: the winding up of a company on the grounds that it is just and equitable to do so; the appointment of an administrator to prevent the dissipation of client assets by a failing broker; and the disqualification of a director of a listed corporation such as where there has been defalcation, fraud, misfeasance or other misconduct. In addition, the SFC may refer cases of suspected civil market misconduct, such as insider dealing, to the Financial Secretary with a view to the appointment of a Market Misconduct Tribunal (MMT) to hear the case. The MMT is chaired by a High Court judge who sits with two lay members selected from a panel drawn up by the Chief Executive.

The third is administrative action. The SFC has been given a range of powers in Part IX of the SFO with which to discipline intermediaries i.e. brokers and those who work for them and the broking arms of banks. The SFC may impose reprimands, suspend or revoke licences or registrations, levy fines and exclude persons from the industry for misconduct including breaches of the SFO or the provisions of the Codes and Guidelines that the SFC has promulgated. Appeals from the SFC's decisions lie to the Securities and Futures Appeals Tribunal which, like the MMT, is chaired by a High Court judge who sits with two lay members selected from a panel drawn up by the Chief Executive.

The primary statutory corporate regulation is the Companies Ordinance (CO) which only applies to companies incorporated in Hong Kong. The CO does not apply to companies incorporated outside Hong Kong, other than to the extent they have a registered office in Hong Kong.

Hence the main regulatory requirement for listed companies that are not Hong Kong incorporated rests with non-statutory rules administered and enforced by the Hong Kong Stock Exchange.

Companies that list in Hong Kong must adopt international standards of practices. As part of the listing process, companies are required to demonstrate to their sponsors that they have adequate procedures, systems and controls to comply with regulatory requirements, particularly those relating to disclosure obligations. Companies coming to the Hong Kong market must adopt international standards on accounting and auditing when preparing their accounts and when their accounts are audited.

They also need to adopt corporate governance practices and processes required by the Hong Kong Listing Rules, including the Code on Corporate Governance Practices. The Listing Rules have detailed requirements to ensure that interests of minority shareholders are safeguarded when a listed company enters into transactions with a major controlling shareholder, that is with a director or a controlling shareholder, directly or via other close family member or via a company that they control. These rules require listed companies to obtain prior approval from minority shareholders for all but the smallest transaction with a connected person.

The Hong Kong Code on Corporate Governance Practice is based on the UK's corporate governance code. It does not prescribe behaviour but sets the standards of best practice that a company should follow or must explain why a particular practice has not been followed.

These standards, and our ability to enforce them, play a crucial role in establishing Hong Kong's credentials as an international financial market. One of the key reasons for companies to list in Hong Kong is the standards that we require of listed companies. I shall highlight in a moment other key attractions that Hong Kong holds for listed companies and investors alike. To retain this role of being the market that helps companies adopt the highest standards of corporate governance, we need to ensure that we continue to adopt the highest standards and set up mechanisms that provide comfort that these standards are being correctly applied and implemented.

Having appropriate standards is not enough in itself. Just as we need an audit process to oversee application of accounting standards, we need adequate regulatory authority to enforce corporate standards and disclosure obligations under the Listing Rules, and the accounting and auditing standards. In this area there is still much work to be done but the necessary work is in train.

Hong Kong's regulatory approach is described as being disclosure based. The SFC and the Hong Kong Stock Exchange are not concerned as to the merits of particular transactions or actions. The onus is on listed companies and their directors to make full disclosure of information needed by investors. It is the regulators' duty to seek to ensure that full and accurate information is provided on a timely basis to the market. Without information investors cannot make informed decisions. It is for this reason that the Hong Kong Government has agreed that there needs to be statutory backing for some of the more important Listing Rules requirements particularly those that relate to disclosure by listed companies. We believe that there are three types of information so fundamental to shareholders interests that they should be subject of statutory rules with strong statutory enforcement powers:-

- a. Financial and other information provided on a regular basis in the annual report, half-yearly and quarterly reports. This provides the basic information needed by investors.
- b. Price sensitive information – this is the information that needs to be disclosed to the market without waiting for the next regular reporting date in order for investors to appraise the position of a listed company, to prevent the establishment of a false market in its shares, or that might be expected to affect market activity or the price of shares.
- c. Information that is sent to shareholders at times when shareholders are asked by the listed company to approve a particular transaction or course of action.

For all of these reasons and more, Hong Kong reflects its status as an international financial centre by remaining at the forefront of evolving best practices. It also earns its reputation as a world class financial market by credible, consistent and impartial enforcement of regulatory requirements and related standards. As in other leading financial markets, delivering on enforcement is a work in progress.

I would like to touch upon some of the ways in which the SFC encourages the adoption and implementation of international standards and principles of corporate governance. In the donkey, carrot and stick analogy, I will focus here on the stick. Why? Because without effective enforcement, even the best compliance standards will not be implemented to the extent necessary to protect the interests of all sectors of the investing public and the integrity of the market.

The SFC will inspect a listed company where there is reason to believe that there is some form of fraud or misfeasance or if there is something to the prejudice of any of its shareholders. The SFC inspection is essentially confined to examining books and records and seeking explanations about their contents. Instead of being empowered generally to investigate the suspected fraud, with broad powers to require any person to answer questions, Inspectors may only ask persons to explain the contents of books and records insofar as such entries – and any instructions on which they were compiled - are within their personal knowledge.

The limited scope of the Inspectors' powers means that the SFC is sometimes unable to unravel the business affairs of a company and unable to require persons who were not directly involved in the production of entries in books and records to answer questions. As a result, the SFC's inspection power lacks the teeth to get to the bottom of fraud and misfeasance in listed companies, which in turn hampers the SFC in obtaining sufficient evidence to present to a Court. In some cases, we can pass investigations to the ICAC or police if the offence is serious enough. In many cases, the lack of sufficiently strong investigative powers makes it hard to pursue offences.

The SFC's role in enforcing – albeit, indirectly - international accounting standards and principles of corporate governance arguably finds its fullest expression in the investigation of what we call market misconduct and other offences under the securities legislation. Market misconduct encompasses, among other things, insider dealing, share price manipulation and the creation of a false market in listed shares.

Where the perpetrators of these offences are executives or substantial shareholders of a listed company, one can often see how the opportunity for committing the offence

stemmed from failure to implement the principles specified in the Code on Corporate Governance Practices.

Directors of listed companies are exhorted by the Code to be fully aware of their responsibilities and duties as a director of the company and to keep abreast of the company's business. Yet, in companies that become involved in market misconduct, or in which the chairman commits the company to contracts that lack economic benefit for the company, it is all too often found that the other directors claim to be clueless about their obligations under the Listing Rules or their role in ensuring that the company is managed properly and in compliance with all legal requirements.

The Code exhorts issuers to implement a clear division of responsibilities at board level for managing the board and managing its business. The rationale is to avoid the abuse of power and the lack of checks and balances on the exercise of power that might occur when too much power is concentrated in the hands of one individual. Such a person may be an executive Chairman, an executive director or a substantial shareholder of the listed company.

This principle of corporate governance, as with many others, is not merely a prudent measure to take; it might even be key to avoiding the plundering of shareholders' funds or the prejudicing of the interests of minority shareholders. Yet it cannot be implemented without the executive directors and independent non-executive directors fulfilling their responsibilities and duties, and for this they need to be kept abreast of the company's business plans and, in the case of independent non-executive directors, empowered to perform their control function in board meetings and through the company's audit and remuneration committees.

We have encountered cases where the over-concentration of power in one individual has enabled him to effectively siphon off shareholders' funds through one device or another. Often, the powerful individual shares little or no information with the board, and directors may be expected to agree to business plans without having sufficient information to understand what they really involve. For example, the company may enter into a contract whereby millions of dollars are paid to a third party with which it is allegedly in talks over a joint venture or a licensing agreement, only for the talks to fall through with the money never recovered. Another example is where assets may be bought for sums far in excess of their real value – it turns out the assets are acquired from an associate of the Chairman. Another is where contracts which purport to be with independent third parties, prove to be with close associates whose profits are shared with you-know-who. The common dominator in such cases is that through arrangements orchestrated by the Chairman or other controlling officer of the company, the company's shareholders funds end up being depleted – perhaps to the extent of threatening the company's solvency – and neither the executive nor the independent non-executive directors are able to impose any control or limit on the company's business affairs through questioning the value of the transactions, or doing the due diligence necessary to ascertain their likely benefit to the company.

Unsurprisingly, when listed companies go bad, announcements issued through the Hong Kong Stock Exchange may be found to have contained false or misleading information. Sometimes this is through concealment of price sensitive information or falsely stating a fact, for example that parties are independent when they are not. Even the Company Secretary might be kept in the dark about the company's business and may be unable to

answer questions posed by regulators when there are unusual movements in the issuer's share price or when asked to clarify the content of announcements.

In such cases, the SFC routinely investigates whether the Chairman, CEO or directors have knowingly or recklessly issued false or misleading information to the Stock Exchange for publication in an announcement. However, difficulties in proving such cases, particularly where the key persons are outside the jurisdiction, have negatively impacted the number of summonses issued for this offence. As at 31 March 2006 there had been convictions on only two such summonses, acquittals on another two and two others are pending trial.

New legislation currently being considered by the Government - giving statutory effect to certain disclosure requirements in the Listing Rules - will significantly enhance the SFC's ability to clamp down on inadequate and misleading information disclosed by listed companies.

However, if the statutory backing were to be limited to the Listing Rules requiring disclosure of price sensitive information, as opposed to the rules that require disclosure of other information such as related party transactions or major transactions, there would be no certainty that listed companies would be held accountable for making full and frank disclosure to the market. In the absence of full, frank and timely disclosure, the market is deprived of the information it needs to assess the value of the company's share price or its prospects. Without proper disclosure of these matters:

- the market is unable to perform its price discovery function,
- the market in that company's shares would lack transparency, and
- investors would be prejudiced by being unable to make an informed decision whether to buy or sell the company's shares.

Therefore, the more comprehensive the statutory backing for the disclosure requirements under the Listing Rules, and the capacity to impose penalties on offenders that would be sufficiently severe to deter disclosure failures, the better the market will perform its functions and the stronger will be the protection of the interests of investors and minority shareholders alike.

In my view, effective enforcement action in respect of these failings and contraventions depends to a great extent upon having: (i) the necessary legal powers at one's disposal; (ii) the resources and expertise to exercise those powers promptly, lawfully and impartially and (iii) the ability to join hands with one's counterparts – whether local law enforcement agencies or overseas regulators.

The SFC has no jurisdiction on the Mainland; our powers under the Securities and Futures Ordinance are exercisable exclusively within the territorial limits of the Hong Kong SAR. It follows that as Hong Kong is the market of choice for Chinese issuers, maintaining the effectiveness of the enforcement apparatus particularly in relation to Mainland issuers is dependent upon the closest regulatory co-operation between ourselves and the CSRC – our equivalent regulator in Mainland China.

Now I should say first, that the SFC enjoys the highest level of co-operation and assistance from the CSRC, and vice versa, albeit limited by the scope of powers currently granted to

the CSRC in its governing legislation. That legislation is undergoing revision and we are hopeful that the CSRC will eventually be endowed with all the powers necessary for it to engage in seamless cross-border enforcement co-operation with the SFC and its regulatory counterparts overseas.

The internationally recognised benchmark for cross-border enforcement co-operation is the Multilateral Memorandum of Understanding Concerning Consultation and Co-operation and the Exchange of Information, promulgated by the International Organization of Securities Commissions – known as the IOSCO MMOU. IOSCO, whose members regulate over 90% of the world's securities markets, enshrined in the MMOU the fundamental prerequisites for a securities regulatory authority to be both fully equipped and able in all respects to engage in comprehensive and effective cross-border enforcement co-operation.

Any IOSCO member that wishes to join the MMOU is subjected to a rigorous assessment of whether its regulatory powers, and its ability to exercise them on behalf of its counterparts overseas, match up to IOSCO's prerequisites for membership of the MMOU. It is our hope that the CSRC will in due course be eligible to join the IOSCO MMOU. When that happens, subject to the resources available to the CSRC, fraud and offences under the securities legislation suspected to have been committed by Hong Kong-listed Mainland companies should be comparable to those conducted within Hong Kong's territorial limits. Essentially, we use each other's powers such as police forces do around the world.

The unpalatable fact remains that without full reciprocity of regulatory and law enforcement assistance between Hong Kong and the Mainland, and without reciprocal recognition and enforcement of civil judgments and the mutual transfer of fugitives between our jurisdictions, the SFC's capacity to take effective enforcement action in cases with a dominant "China Factor" is seriously impaired. The inability to have investigations conducted in the Mainland translates into a lack of evidence with which to support prosecutions or enforcement action in Hong Kong, and this should be recognised.

How, then, is the SFC's effectiveness in reinforcing compliance with international standards and corporate governance to be measured? As an accountant myself, I freely admit to having a weakness for figures – statistics, that is.

Since May 1998, the SFC has initiated 57 listed company inspections. These have resulted in one referral to the Financial Secretary (for consideration of referring the matter to the Market Misconduct Tribunal), 18 referrals to the Police, 7 to the Stock Exchange and 4 to the ICAC plus one to the Hong Kong accountancy body. These figures do not include the referrals made to the ICAC and the Police arising from other inquiries and investigations handled by the Enforcement Division of the SFC.

Stemming from inspections undertaken by the SFC of Mainland companies listed in Hong Kong, we have one case which depleted shareholders' funds to the tune of about US\$1.3 million – we are seeking to ban a director from holding the directorship of a listed company for such period as the court thinks fit. We also propose launching another similar petition to obtain banning orders against 5 former directors of a previously listed company, for misfeasance, misconduct and failing to discharge properly their duties and responsibilities as directors of a listed company.

Between May 1998 and 31 March 2006, the SFC has issued 104 summonses for market manipulation of various kinds of which 4 are pending trial. Of the remainder, 80% of entities were convicted.

From 1 January 1993 to the end of March 2006, 28 cases of suspected insider dealing were referred by the Financial Secretary to the Insider Dealing Tribunal. Of those, 7 cases are outstanding and one is pending final resolution. Out of the 20 concluded cases, insider dealing was found to have taken place in 17 of them – which represents a staggering 85% success rate. In addition, the Tribunal banned 41 persons from holding directorships in listed companies for periods ranging from 6 months to 4 years – which is a useful measure to protect the investing public.

As I have said, effective enforcement action frequently depends upon close co-operation between the SFC and local law enforcement agencies: the ICAC and the Police. A recent case in point involved manipulation of the share price of Shanghai Land Holdings Limited and other offences. As a result of the ICAC's investigation, in which the SFC was able to render some assistance, individuals were brought to trial in the District Court. Relying in part on the evidence of one of our in-house experts, the court convicted the defendants and sentenced them to immediate imprisonment for terms ranging from 6 months to three and a half years. Similar successes have also resulted from police investigations, demonstrating the important role of inter-agency teamwork in bringing offenders to justice.

Let the unequivocal message conveyed by these results be heard and understood, both locally and internationally: enforcement is a strategic priority of the SFC. Contraventions of securities laws and regulatory requirements, whether stemming from corporate governance lapses, deliberate fraud or otherwise, will not be tolerated and offenders should expect to be brought to justice.

But we shouldn't get carried away with statistics. The effectiveness of an enforcement mechanism is not measurable solely in terms of the number of persons convicted of insider dealing. Nor is it gauged by the number of disciplinary cases resulting in the imposition of disciplinary sanctions.

As important as these statistics are, I firmly believe that it is equally important that they are seen as merely one aspect of the performance of the SFC's enforcement function. Behind the statistics is the unwavering commitment to exercise powers of inquiry and investigation without fear or favour in furtherance of the SFC's mission to protect investors and to keep the markets orderly and transparent for all participants.

The SFC's enforcement record, both the cases in which regulatory action has been successfully concluded and those which did not result in the imposition of penalties or sanctions, speaks eloquently of Hong Kong as a jurisdiction where the rule of law prevails and where justice takes its course.

I firmly believe that, despite the current gaps in cross-border enforcement co-operation in relation to Mainland companies and executives who disappear across the border before they can be brought to justice, all these factors exert a potent attraction on issuers to list, and investors to invest, in Hong Kong.

On balance, the development of the Hong Kong market depends upon our ability to rise to challenges and on our willingness as a community to pursue the course that we believe is in Hong Kong's best interests. It is my firm belief that Hong Kong will succeed decisively in establishing itself as the region's international capital market of choice. For my part, I am unswervingly committed to guiding the SFC to play to the maximum its role in bringing this about – in partnership with our stakeholders, including the Administration, our law enforcement agencies and our counterparts around the globe.

Thank you.