Aiming high: Regulation for quality markets

Hong Kong General Chamber of Commerce's Town Hall Forum Series

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Chairman

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Good afternoon, CEO Shirley Yuen, Vice Chairman Leland Sun, ladies and gentlemen.

I would like to thank Shirley for asking me to speak at the HKGCC's Town Hall Forum Series.

You have actually just caught me in time as this time next month, I will be retiring as Chair of SFC, my second retirement since I retired from KPMG in 2011.

Today I will share with you a range of topics covering the SFC's new regulatory approach to tackle corporate governance problems and listed company misconduct.

I will also share some thoughts on the role of independent non-executive directors (INEDs), some recent regulatory changes covering WVR companies and backdoor listings and, last but not least, our close cooperation with Mainland counterparts.

Corporate governance

In my 30 years as a practising accountant, followed by six more as a regulator, corporate governance has always been close to my heart.

Throughout my career, I have seen a fair deal of high-profile corporate failings both at home and abroad.

Ten years ago this week marked the height of the Global Financial Crisis. Looking back, Lehman Brothers and AIG provided hard lessons in corporate governance. We learned the hard way why ethical corporate behaviour and good governance are crucial.

One major takeaway from the crisis is that corporate governance goes a long way to help both public and private companies operate with greater transparency and accountability. It also helps create a level playing field for businesses and supports capital market development in the long run.

Now as HKGCC members comprise more than half of the flagship corporations in the Hang Seng Index, clearly corporate governance is as relevant to you all as it has been to me.

I believe the key to good corporate governance is the tone at the top and having in place a strong and effective board. INEDs play a critical role in this. I will therefore be sharing with you my thoughts on the role of INEDs.

Note: This is a drafted version and may differ from the one delivered.

But first of all, I want to talk about the new regulatory approach taken by the SFC starting two years ago to tackle some persistent problems in our markets, especially market misconduct and suspicious corporate transactions.

The SFC's front-loaded approach

Let's be clear, when things do go wrong, it can be catastrophic for everyone, companies as well as investors. With this in mind, the SFC began to take a more proactive approach to tackling corporate misconduct and safeguarding the interests of investors.

We adopted what we call a real-time, front-loaded approach to regulation. This means getting ahead of threats, delivering fast and responsive regulation, and maximising the impact of our actions.

Under this new approach, we use the SFC's existing statutory powers under the Securities and Futures (Stock Market Listing) Rules (or SMLR in short), and more generally under the Securities and Futures Ordinance (SFO), to deal directly with listing applicants when we have concerns about initial public offerings (IPOs) and with listed companies on their corporate actions.

Last year, there were around 40 cases which involved the potential or actual use of our SMLR powers. This is a big change from the past, when there were just two or three cases per year.

In 2016, we set up a cross-divisional taskforce called "ICE" to pool resources from the Intermediaries, Corporate Finance and Enforcement divisions. The taskforce made good progress in tackling listing matters affecting the quality of our markets. We now raise objections to listings or capital raisings and we direct suspensions of shares where necessary.

To add some meat to this, let me give you some real-life examples:

<u>Listing applications</u>

High shareholding concentration

In one case, we found that after listing, a company's top 25 shareholders would hold over 99% of its total issued share capital. This is an extremely high shareholding concentration and it's no surprise that it raised a lot of questions. Would there be an open market and an orderly and fair market for the shares? Clearly not, so we exercised our power under the SMLR to object to the listing application.

Connection with largest supplier

In another case, we were concerned that a listing applicant provided false or misleading information about its relationship with the largest supplier. The applicant described the supplier as an independent third party, but it was clear that there were connections between the applicant and the supplier, including cross-shareholdings. This prompted us to wonder about the applicant's trustworthiness and its relationship with the supplier. Again, no surprise, the applicant eventually withdrew its listing application.

<u>Corporate actions</u>

We can also point to a number of corporate transactions that were terminated or restructured as a result of our recent regulatory actions.

Placing of new shares at a substantial discount

We had one case where a listed company proposed to place new shares to a small group of investors at a substantial discount. This would transfer control from the existing controlling shareholder to the new investors. Even more suspiciously, some of the investors may have been acting as nominees for persons unknown. After several rounds of SFC enquiries, the company terminated the proposed placing.

Unneeded and dilutive fundraising

Another example: a listed company completed two highly dilutive fundraisings within a year, and was proposing a third round. We found this a bit suspicious because the company did not seem to have an urgent need for funding on any of these occasions. After investigating, we discovered undisclosed connections between some of the company's directors and the shareholders who voted to approve the fundraisings. More alarmingly, the directors may be connected with parties who subsequently acquired the company's shares in the fundraisings. Considering these facts and the impact of another round of fundraising on shareholders, we directed a suspension of trading in the company's shares.

Acquisition with convertible bonds

A more extreme case involved a listed company which proposed an acquisition through the issuance of convertible bonds at a more than 60% discount to the market price. If fully exercised, the conversion shares would represent more than half of the enlarged issued share capital. We were worried that the acquisition was a way to obtain a listing without going through the usual application process. We made enquiries and issued a letter of concern, but the company could not offer any reasonable explanation. The planned placing was subsequently scrapped.

INEDs

Now you may have noticed that in many of the cases I just mentioned, we combined the use of our statutory powers under the SMLR with our investigation and other enforcement tools.

This is because the SFC has a statutory duty to administer the SFO which allows us to investigate and pursue a range of criminal and civil actions against wrongdoers. This includes directors and senior executives who have the responsibility to protect shareholders' interests.

During the first half of 2018, 60 listed company directors were subject to disciplinary sanctions. These included 36 executive directors, five NEDs and 19 INEDs. This is a four-year high. So that's a pretty clear sign that there is an issue with the quality of company directors.

According to our Annual Report, from April 2013 to March 2018, the number of corporate mis-governance cases under the SFC's investigation jumped from 41 to 72, an increase of more than 70% in just five years' time.

You may recall the case of Freeman FinTech Corporation Limited two years ago. We commenced legal proceedings under the SFO to disqualify 10 former executives and NEDs for breach of directors' duties. We also sought a court order that the managing director and one NED compensate Freeman $76.8 million, equivalent to the alleged loss they caused to the company. I cannot comment further at this stage as the proceedings are still ongoing.

In this and other cases, such as Far East Holdings and Hanergy Thin Film, we went after senior executives and non-executive directors and held them accountable for their wrongdoing.

These enforcement actions are necessary, but are they the best way to prevent misconduct? To my mind, the very best way is stronger corporate governance on the part of companies in Hong Kong. Too often NEDs and INEDs are over-reliant on executive directors or management without understanding the importance of their role in establishing and maintaining a sound corporate governance framework.

A step in the right direction to raise overall governance standards was the Stock Exchange's recent proposed changes to its Corporate Governance Code. The new measures cover the transparency and accountability of the board, independence of INEDs, over-boarding and board diversity, and will take effect in 2019.

Backdoor listings and shell activities

The next topic I would like to touch on has drawn considerable interest over the years.

This is the huge demand for shell companies for backdoor listings and the significant increase in the value of shells.

The problem with backdoor listings is that they circumvent the normal listing requirements. Assets are injected into a listed company without the proper due diligence normally undertaken by IPO sponsors, and with very limited disclosure of the new business.

This raises doubts about whether there is a fair and orderly market.

One may argue that such activities are limited to a small segment of the market. Nevertheless, they could lead to market manipulation, insider trading and excessive volatility, to name but a few, resulting in substantial harm to our markets and investors.

To deal with these issues, we have been working closely with the Exchange over the past few years. The resulting consultation on backdoor listing and continuing listing criteria which ended last month is the fruit of these efforts.

In short, it is proposed that the reverse takeover rules and continuing listing criteria be tightened to prevent backdoor listings, particularly those involving shell companies.

This involves tightening the existing principle-based test by including change in control or de facto control and also extending the bright line test for a series of transactions from two years to three years.

In assessing whether there is a change in de facto control, the following will be taken into account:

- any substantial change in its board of directors and key management
- any change in its single largest substantial shareholder
- any issue of restricted convertible securities

As you can see from the press release we issued on the same day the consultation was launched, the SFC is highly supportive of these proposals. They are a key part of broader efforts to address problematic corporate and market conduct in the regulation of listed companies.

So we will certainly keep a close watch where these issues are concerned. Where intervention is justified, we will not hesitate to employ our front-loaded approach to combat listed company misconduct and other serious issues.

Weighted Voting Rights and biotech companies

Another topic which should be of interest to all of you is the new listing regime which allows listings of pre-revenue biotech firms and companies from emerging and innovative sectors with WVR structures.

As you might be aware, following the SFC's approval, the Exchange issued new rules to expand Hong Kong's listing regime earlier this year.

As part of Hong Kong's strategy to diversify the mix of companies listed here, the new regime will enhance the competitiveness of our markets and help attract Mainland and international capital.

In many ways, the new regime is ground-breaking—Xiaomi, the first company with WVR structures to list in Hong Kong, commenced trading on 9 July, while Ascletis Pharma, the first pre-revenue biotech company to list here, began trading on 1 August.

The new listing regime also provides a concessionary secondary listing route for Greater China and international innovative companies listed on qualifying exchanges overseas.

More significantly, Hong Kong is the first major jurisdiction to have its own WVR regulations. This is truly unprecedented.

Of course, we must prioritise investor protection in allowing such listings. A number of ring-fencing measures are in place to make sure that WVR does not become the norm in our markets.

For instance, listing applicants are subject to a set of stringent criteria, including detailed suitability and enhanced disclosure requirements as well as a higher market capitalisation threshold.

For WVR companies, there are limits to their WVR power and rules to protect non-WVR holders' right to vote. There are also enhanced corporate governance requirements.

To address concerns that biotech firms without a track record of profitability may become easy targets for backdoor listings and shell activities, measures were introduced to streamline the de-listing process and prohibit fundamental changes in business.

You may also have heard about the Exchange's recent decision to delay the launch of a consultation on its proposal to allow corporate entities as WVR beneficiaries. I do not have much to say about this at this point, but you can all rest assured that this issue will remain on the SFC's radar.

Cross-border connectivity

Before we move on to the Town Hall Conversation, I would like to talk a bit about our relationship with mainland China.

Right from the start, Hong Kong has been uniquely positioned to benefit from greater cross-border connectivity as the Mainland opens up.

The first H-share listing of Tsingtao Brewery in 1993 marked the beginning of a new era for the development of our capital market. Today, we have 260 H-shares listed in Hong Kong, with Mainland companies comprising more than 60% of our market capitalisation and over 80% of our market turnover.

The subsequent launch of Stock Connect and the Mutual Recognition of Funds (MRF) arrangements are just a few examples of our increasing market integration and close collaboration with the Mainland.

This will be key as the scope of our mutual market access programmes broadens over time. In fact, we are in discussions with the China Securities Regulatory Commission (CSRC) to expand the scope of Stock Connect, Bond Connect, ETF[1] Connect and MRF.

More than ever, Hong Kong's ability to strengthen its competitiveness as an international financial centre hinges on the success of these cross-border initiatives.

And with the increased presence of Mainland-backed, SFC-licensed corporations and Hong Kong-listed Mainland companies, the regulatory interests of the SFC and the CSRC are increasingly aligned.

Late last year, we entered into an MoU with the CSRC on regulatory and enforcement cooperation in the futures markets. This cooperation enabled us to manage common risks better and laid the foundation to develop Hong Kong as a centre for managing exposure to the Mainland market.

And in June this year, we entered into a memorandum of understanding (MoU) with the China Banking and Insurance Regulatory Commission to enhance cooperation in the supervision and oversight of financial institutions that operate on a cross-boundary basis.

Conclusion

So to sum up, bilateral and reciprocal regulatory cooperation will be key to Hong Kong's future as a leading international financial centre and a major hub for two-way capital flows.

In this regard, we share the same goals as HKGCC in facilitating meaningful market development and maintaining the integrity and quality of Hong Kong's markets.

As ever, I greatly appreciate the HKGCC's efforts to promote and safeguard the interests of the business community and to facilitate its growth over the past 157 years.

Thank you.

[1] Exchange-traded funds.