

## Board leadership: looking ahead

### The Hong Kong Institute of Directors Speaker Luncheon Meeting

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Chairman

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Good afternoon. First, I want to thank you for inviting me to speak to you today. The Hong Kong Institute of Directors has long played an important role in promoting good corporate governance in Hong Kong, and I am sure you will keep up this tradition.

Many of you know that I took up the chairmanship of the Securities and Futures Commission (SFC) in October last year. So far, what I can say is that it has been challenging. The markets are increasingly complex and there is a lot happening in the world today. But the SFC's work is also deeply meaningful. It aims at one overarching goal, which is to maintain Hong Kong's competitiveness. Under the law, our key objectives include investor protection and ensuring fair and orderly markets. Without these, Hong Kong cannot compete as an international financial centre.

All of you here have a key role to play in this too. So I would like to take this opportunity today to give you an update on some of the things the SFC is doing that company directors need to know about.

#### Getting out in front

The biggest change at the SFC in recent years has been in our regulatory approach to listed companies. Starting in 2017, we have made some fundamental changes in response to patterns of misconduct and other problems we were seeing in the market. To address them, we saw that we needed to be more proactive and intervene at an early stage to prevent harm to investors and protect market integrity.

We took a hard look at how we were using our regulatory tools and specifically how we could use the power already vested in us more proactively. For example, when we vet listing applications, we used to stay in the background and let the Stock Exchange interact with the applicant. Now, we may make enquiries to the applicant directly if we have concerns about a listing application.

This has serious implications for directors. Let me give you some real-life examples. One listing applicant was in the retail business, but it diversified into wholesaling during the track record period. It submitted documents with its application showing that revenue rose

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Note: This is the text of the speech as drafted, which may differ from the delivered version.

significantly in the previous year due to its marketing efforts and sales to a wholesaler which on-sold its products to an e-commerce platform.

When we looked into this, we found that the marketing efforts only began near the very end of the track record period, and sales of its products on the e-commerce platform were minimal. This made us sceptical, and we were concerned about whether the applicant's financial information gave a true and fair view of its business performance.

We wrote to ask the applicant to explain and substantiate its significant revenue growth, but it was not able to provide satisfactory explanations. In the end it withdrew its listing application.

So you can see how intervening directly and early on can help identify substandard companies and keep them out of the market. This helps prevent the harm to investors that may occur if they achieve a listing.

Now I would not want to be one of the directors whose name appeared on that listing application. Even though it was withdrawn, the directors can still be liable for any false or misleading information provided in a listing application.

The important lesson here is that as a director, you should have a solid understanding of the business, and raise questions if something does not seem right. This is part of your fiduciary duties to the company, which you should always keep foremost in mind.

Let me tell you about one more case. We noted from the applicant's share allotment information that while the total number of shareholders exceeded the minimum of 100 required by the GEM Listing Rules, the vast majority of the total issued share capital would be held by a small number of shareholders. This meant that upon listing, the public float would be very small, making it easier to manipulate the share price. We have been talking about this kind of thing a lot, and the applicant's directors should have been paying attention.

For one, the SFC and the Stock Exchange issued a joint statement about this very issue in early 2017. We made it clear that directors are responsible for ensuring compliance with the Listing Rules, including that there is an open market for the shares and an adequate spread of shareholders, and that the percentage of shares in public hands meets the requirements. The extremely high shareholding concentration in this case made us doubt whether this could be achieved. We issued a "letter of mindedness to object" to the applicant, and it postponed its listing. It later relaunched its share offer with a wider spread of shareholders.

So you can see it is very important to pay heed to our guidance so you understand the rationale for what we are doing as well as our expected standards. We try to be as transparent as we can.

One guidance note you should be aware of was on directors' duties to address problematic valuations in corporate transactions<sup>1</sup>. Our main concern was with listed companies acquiring assets at unreasonably high prices or selling assets which were substantially undervalued, and the harm this can cause to shareholders' interests. So we made it clear that directors are expected to exercise critical judgement and carry out independent due diligence regarding the asset or target company. Specifically, they should not overly rely on the advice of valuers

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<sup>1</sup> See the [press release](#) dated 15 May 2017.

or financial advisers. They should make sure for themselves that the assumptions used are reasonable and objective.

Another part of this new regulatory approach has been to work very closely with the Exchange to make changes to the listing rules to address some specific problems such as highly-dilutive capital raisings and backdoor listings. Fast-track procedures for delisting were also introduced.

Two years on since we have adopted this new regulatory approach, it is clear that using our powers more directly and independently has been effective and synchronises well with the Exchange's roles.

One evidence is the much healthier GEM. A few years ago, it could be common to see share price hikes of multiple times on GEM, sometimes even up to 20 times just on the first trading day. But through our efforts, there has been a big change in behaviour and such extreme volatility is rarely seen today.

#### *Listing rule enhancements*

There is still more we can do to uphold high standards in our market. Just two weeks ago, the Exchange published a consultation conclusions paper on a new trading suspension requirement for listed companies that publish financial statements with disclaimer or adverse opinions from their auditors.

This is clearly necessary. For the 2017 financial year-end, 43 listed companies published financial statements with a disclaimer of opinion. Of these, 24 companies – more than half – received disclaimers of opinion ranging from two to seven consecutive years.

I have been a practising accountant throughout my career. I would say that a disclaimer or an adverse audit opinion calls into question the credibility of a company's financial statements. Investors will not have confidence that they can rely on these accounts to make an informed assessment of the company's financial position. When this happens repeatedly, it raises concerns whether the companies have acted properly to resolve the issues with their auditors.

So the new suspension requirement will help protect investors by improving the quality and reliability of financial information. Company directors are required to look into the issues and resolve them promptly with their auditors. More broadly, we hope it would encourage companies to maintain appropriate and effective risk management and internal control systems.

#### *Enforcement and deterrence*

It is worth noting that the SFC's new front-loaded approach does not in any way replace or diminish our enforcement efforts. In fact, corporate fraud has been our top enforcement priority and we have been more active in bringing both civil and criminal proceedings when we find wrongdoing. This involves directors. Since 2017, the number of directors we have removed or banned for fraud or similar breaches has doubled.

Just last week, we announced that we are seeking a court order to disqualify another former company director. We alleged that he failed to discharge his duties as the chief financial officer and an executive director when funds from the company's global equity offering were

withdrawn, even though he knew about red flags. The matter is now subject to pending court proceedings.

IPO sponsors also play an important role as gatekeepers to maintain the quality of our market. The SFC is charged with making sure that sponsors uphold high standards, and from recent news headlines you may have seen that the SFC imposed fines of about \$900 million in disciplinary actions against eight sponsor firms and three sponsor principals. In these and many other cases, we found that sponsor firms and principals failed to verify key information and exercise professional scepticism.

These fines were meant to be a strong deterrent message, and we hope they help improve due diligence and remind everyone in the market to perform their gatekeeping roles properly.

This clearly includes company directors. In IPO fraud cases, we will not only investigate sponsor due diligence failures, we will also hold the directors responsible for the disclosure of false or misleading information. These could result in civil action against the directors.

### **Business and sustainability**

Let me turn now to another topic that has taken on increasing urgency in the past few years. This issue promises to be a major challenge for business for many years to come. I am talking about green finance and sustainability.

Climate change is now recognised as posing significant economic and financial risks as well as opportunities. Directors should understand what these risks and opportunities are, assess how they affect their companies and ensure necessary disclosures are made.

The starting point is to be aware that the law requires all Hong Kong-incorporated companies to disclose a discussion of their environmental policies and performance in their annual directors' reports<sup>2</sup>. Last November, the Exchange updated the ESG<sup>3</sup> guidance, reiterating that the board of directors has the overall responsibility for a company's ESG performance. It also reminded companies to assess the ESG issues which are material to their business and operations, and develop a risk management strategy specifically for dealing with them.

For example, if the Hong Kong Observatory reports that it expects more typhoons this year, how will this affect you? Business operations may be suspended, or your supply chain may be disrupted. And if new laws or regulations are introduced to address the threat of climate change, this may raise your compliance costs, or other costs of doing business. On the other hand, government efforts to combat climate change could provide opportunities for companies in clean energy and other environmentally-friendly businesses. The key here is to identify the risks and opportunities, and quantify them to the extent possible.

Investors are now demanding more information and international regulators have recommended that companies worldwide provide voluntary disclosures of their climate-

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<sup>2</sup> Schedule 5 of the Companies Ordinance. These were incorporated into the Listing Rules as mandatory disclosure requirements for all companies listed on The Stock Exchange of Hong Kong Limited regardless of their place of incorporation.

<sup>3</sup> Environmental, Social and Governance.

related financial risks. Companies that get out in front of this will find a lot of investors waiting to jump on board.

If your company has not already done so, it can begin with small steps such as including sustainability discussions in your board meeting agendas. You can set up an ESG working group reporting to the board and made up of senior management and staff familiar with both ESG matters and the company's operations.

There are also some important questions you should be asking. Is your company prepared for this? What are the implications for company directors? Are you tracking the relevant information internally? Does your company have a proper governance structure in place to handle ESG matters?

One more development to keep in view is the Exchange's consultation launched last month<sup>4</sup> on listed companies' ESG governance and disclosure. A key emphasis is on the board's leadership role and accountability. The consultation also highlight the importance of meaningful ESG reporting, which is now a global trend.

## **Conclusion**

So looking ahead it is clear that in the years to come, senior management accountability and board leadership will be key not only to good corporate governance, but also to ensuring sustainable economic growth and protecting the environment.

From our perspective, at the SFC we will remain committed to raising governance standards to keep our markets orderly and competitive. This would not be possible without the concerted efforts from individual practitioners, industry associations like yours and our fellow regulators in Hong Kong and around the world.

Thank you again for having me today.

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<sup>4</sup> See the [consultation paper](#).