

**LegCo Briefing Notes – Enron and Corporate Governance**

**(Speaking note of the representative of the  
Securities and Futures Commission)**

1. Enron was a business failure on a massive scale. The US authorities are still investigating what happened. But based on published information it seems that it was not the business failure that mattered – it was the apparent cover-up, and this involved a failure of corporate governance. The global reaction now focuses on what can be done to improve governance structures.
2. There are two main issues:
  - First, improving the integrity of information disclosure: fast, reliable information is the fundamental principle of investor-based capitalism.
  - Second, defining the roles of the various intermediaries in order to improve information flow and the integrity of information. These include auditors, investment banks, analysts and directors.
3. Corporate Governance was identified as a priority area in Hong Kong well before Enron. Good governance is key to maintaining Hong Kong as a leading international financial center of quality. The SFC has been heavily involved in a number of initiatives aimed at increasing Hong Kong's lead over other Asian markets as a benchmark for governance standards. We already have some of Asia's best corporate governance standards. We will become better. We are now in the midst of two major projects – the Listing Rules and the Standing Committee on Company Law Reform (SCCLR) corporate governance reviews, both of which started before Enron. Enron has now put the issues under a spotlight. Lessons drawn from Enron will be invaluable in enabling us to develop these proposals in line with international best practice.

4. I would like to deal first with what has been done so far. I apologise if this deals with some ground covered by the Secretary for Financial Services.

- First, the Securities and Futures Ordinance enacted yesterday. This has been the major focus of the SFC's policy work to date and has taken a huge effort, not least from LegCo members. The SFC is grateful for their support. We believe that the Ordinance will have a positive impact on governance, and I will give a few examples.

(i) The time limit for disclosure of directors' dealings has been reduced from 5 days to 3 business days and the percentage disclosure limit has been reduced from 10% to 5%. This is in line with one of the "10 point" proposals announced by President Bush last week.

(ii) The scope of investigations into Listed Companies conducted by the SFC has been widened. With expanded powers we will be able to look into and get explanations of the records not only of listed corporations but also their auditors, banks and transaction counterparties. We can more effectively be able to enquire into misconduct which prejudices shareholders interests.

(iii) The Market Misconduct provisions establish civil liability and criminal offences relating to false and misleading information inducing securities transactions. There is also a new private right of action for those who have suffered loss as a result of market misconduct. They can seek compensation from those responsible for it.

(iv) Investors will also have a new private right of action to seek compensation for losses arising from reliance on false or misleading communications, including those issued by listed companies.

(v) Finally, auditors will have statutory immunity when communicating suspected corporate misconduct to the SFC.

5. We have also been working on other fronts.

- We have worked closely with Hong Kong Exchanges and Clearing Limited (HKEx) on its major Corporate Governance proposals for the Listing Rules, released earlier this year. This is now under public consultation and we are sure that the Enron story will influence the public response and the eventual outcome. HKEx will deal with these proposals in more detail. I should only note here that many proposals reflect international best practice.
- We are represented on the SCCLR and actively participate in both the main committee and the subcommittees dealing with shareholders and directors. The main focus of its work for over a year now has been corporate governance. It released Phase I proposals last year and is now working on the remainder. The Phase I proposals are wide ranging. They include a recommendation to give shareholders a statutory derivative action to sue on behalf of a company. The SCCLR also recommends that the SFC should have the power to bring derivative actions in the public interest. If this proposal is adopted our ability to take action to protect shareholders rights would be considerably enhanced. The SCCLR further recommended that the composition of the Hong Kong Society of Accountants' (HKSA) standard setting bodies be widened to cater for more involvement by the public.
- The SFC has established a "Shareholders Group" to advise it about matters which concern investors, which I chair. It has held two meetings to discuss a draft of the Exchange's Corporate Governance proposals, and it has just met to discuss problems posed by penny stocks and options for delisting failing companies. Its deliberations are made public and are fed to decision making bodies.
- We are closely involved with the accounting profession, mainly via the HKSA. We participate in regular, formal tripartite meetings between the Exchange, the HKSA and ourselves. Given the manner in which Enron has re-ignited the debate about auditing, I expect that we will spend a lot of time with the HKSA

over the coming months dealing with implications for the accounting profession.

- In October last year and January this year we introduced comprehensive changes to the Takeovers Code, again to ensure that we are in line with international best practice. The Code governs how companies and directors must behave in merger situations.
- In January this year, following public consultation, we introduced a Code of Conduct for Corporate Finance Advisers, which specifically addresses the role of these crucial “gatekeepers” when advising listed companies. The Code should incentivise advisers to ensure that corporates adhere to strict disclosure and governance standards.
- Andrew Sheng, our Chairman, chairs the Steering Committee on Enhancement of Financial Infrastructure or “SCEFI”. This is examining the introduction of scripless trading. A dematerialized structure would be of great help in enabling shareholders who use the new clearing system to participate directly in corporate decision making.
- We are reviewing the legal structure relating to offers of investments. We are redoubling our efforts to update the legal and regulatory requirements so as to enhance market development whilst providing appropriate protection to retail and professional investors.

## **THE FUTURE**

1. We have done a lot, but there is clearly more to do. We are now in the midst of a local and global debate about corporate governance. The pace of this debate has accelerated in Hong Kong and internationally because of Enron. I will now deal with what I envisage to be our main action points in the short to medium term.

- The Securities and Futures Ordinance gives the SFC a new basis for regulation in the area of corporate misconduct. We intend to intensify discussions with the Exchange and Government in order to identify those areas where the SFC should play a key role as a statutory enforcement agency in serious cases, and in particular where corporations have failed to comply with best practice disclosure standards. The Ordinance should enable the SFC to perform a bigger de facto role as corporate regulator for the listed sector.
- We will participate in the important debate about accountants and audits. Auditors have a unique public interest role in ensuring the integrity of information disclosure. Topics which we envisage will be at the forefront of discussion include:
  - The regulation of auditors;
  - Auditors independence;
  - The way in which companies appoint auditors; and
  - The role of the audit committee.
- I should point out that the SCCLR has suggested that an independent body be established with authority to investigate financial statements and enforce any necessary changes. This is similar to the UK Financial Reporting Review Panel. We will participate in discussions arising from this proposal.
- As far as auditing standards are concerned, Hong Kong follows most of International Accounting Standards (IAS) in Hong Kong's Generally Accepted Accounting Principles (GAAP). IAS emphasizes "substance over form" and provides more protection than US GAAP in the context of Enron-type special purpose vehicles. In general, we welcome the development of standards that result in financial statements that describe in plain English the economic reality of the company's transactions.
- We will continue to participate directly in the international debate generated by Enron, particularly at IOSCO, the international organization of securities

regulators. We have recently hosted the IOSCO Technical Committee meeting in Hong Kong and one of my directors is now in Canada participating in the IOSCO committee dealing with disclosure issues.

- We will have direct input into “Phase 2” of the SCCLR’s Corporate Governance project, which will deal, among other things, with audit and other governance committees, as well as the structure of company boards.
  - Recognising the growing importance of Mainland companies to the Exchange we intend to intensify discussions with the China Securities Regulatory Commission about cross-border cooperation, particularly in the area of investigation and enforcement.
  - Finally, we will work with the Exchange to assess the public response to its major corporate governance consultation. I believe that the lessons drawn from Enron will have a major impact on the outcome of the consultation.
2. Overall, I believe that in short order we will have enhanced our corporate governance rules to standards comparable with the best in the world. But we must be realistic. Enron shows that corporate governance structures might be adopted by corporations, but they may well not work. Successful corporate governance requires real commitment by corporate managers and not just lip service. Regulators can assist in two ways.
- First, we can educate all involved to understand that corporate governance is in their financial interest. There is plenty of empirical evidence that corporate governance is an increasingly vital attribute to access global capital cost-effectively. Market forces will also play a part. An example is the growing corporate governance rating business developed by Standard & Poors. Investor education has for some time been an SFC priority, and in the area of Corporate Governance we will consult our Investor Education Advisory Committee on the way forward. We will also continue discussions with Hong Kong Institute of Directors, among others, about the education of directors.

- Second, we will intensify our talks with HKEx and Government with a view to ensuring credible enforcement where there are serious disclosure failures. We must identify possible areas for improvement to our enforcement efforts and we are open to views on this.

Finally, I should mention that although we should benchmark to international standards, our regulations and our approach to enforcement should also recognize that in Hong Kong and Asia we have local governance problems, often associated with a predominance of family controlled companies. The SCCLR's terms of reference for its governance projects explicitly recognize this. This leads to greater challenges for those governance structures that are founded on independence from management. A good example is the role of independent directors. These local issues should be assessed in the context of the Listing Rules consultation, as well as the SCCLR's deliberations.

Thank you.