

**Statement by Mr Andrew Sheng,
SFC Chairman
Before LegCo Panel on Financial Affairs
6 November 2003**

Mr Chairman,
Honourable Members,
Ladies and Gentlemen,

1. I am very honoured to be invited to comment on the Corporate Governance Action Plan. The Commission has been working very closely with the Administration and the HKEx on different aspects of this Plan.

2. Many of the Priority Areas in the joint Corporate Governance Action Plan are being led by HKEx through its Listing Committee, supported by the Listing Division. I would like here to deal mainly with items in the Plan that are principally the SFC's responsibility. But first I would like to comment on the major project now under the Exchange's wing.

3. This is "Priority 1" - upgrading the listing rules and listing functions. At the heart of this initiative will be a new Corporate Governance Code for Hong Kong. I have two brief points on this project: -

- (a) First, although Hong Kong is consistently rated at the top of Asian corporate governance rankings, the fact remains that the current corporate governance Code in the listing rules is well out of date. It was last revised over five years ago, before the Corporate Governance revolution triggered by the bursting of the equity bubble and the scandals in the US. To move from the current Code to one that reflects the new standards in London and New York involves a significant change and requires careful consideration on the part of the Listing Committee. The Listing Committee needs to ensure that a new, comprehensive Code will operate effectively in Hong Kong. They may also need to consider appropriate transition periods to allow companies to "catch up" with new standards. The Committee has also had to take account of significant new developments overseas and locally - notably the UK's new Combined Code and the Standing Committee on Company Law Reform's (SCCLR) Phase II Consultation Paper, both released in this summer. Both are major undertakings with profound recommendations

and legal and practical implications. We are delighted that the Listing Committee members, under the able leadership of Mr Marvin Cheung, all of whom are voluntary, have tackled this difficult task with a high level of commitment. They have devoted a very large amount of unpaid time so that we can end up with a Code that will enable Hong Kong to underpin its status as a leading international financial centre with world-class governance standards. The SFC agrees that caution is necessary, and that it is better to introduce properly thought-through principles that work rather than rushing through changes that may lead to unintended consequences and have high compliance costs. I believe however that we are nearing the end of the current cycle of global corporate governance reforms and now the time is right to upgrade Hong Kong's governance standards. We therefore look forward to assisting the Exchange to introduce the new Code in the first quarter of next year.

- (b) My second point is that the toughest challenge will follow publication of the new Code. It has been remarked on many occasions that one cannot legislate for ethics. It is easy to pay lip service to Corporate Governance - success depends on the corporate sector adopting a real commitment to ethical business practice and fair treatment of corporate stakeholders. I believe that is the case in Hong Kong. Hong Kong's corporate governance will be judged against whether the new Code is complied with in substance - for example whether audit committees operate as effective checks and balances, whether internal control mechanisms address real business risks and whether independent directors add value. This requires strong leadership from the wider community and in particular acceptance and ownership by the corporate community. There is also a clear role for institutional investors to endorse the new Code. The Administration, the Commission and the Exchange will of course do everything they can to advocate and promote the new standards. However it is even more vital that business gives visible support and leads by example, demonstrating why good governance makes good business sense, and why it is vital to ensure Hong Kong remains at the forefront in Asia. In this context we support the introduction of more formalised training for directors.

4. There are three Action Plan priorities for which the SFC has primary or joint responsibility.

The first is Priority III – "Effective Roll out of the SFO"

The Securities and Futures Ordinance (SFO) came into effect in April. Two aspects are particularly relevant to Corporate Governance - our enforcement efforts against corporate

misconduct and the new "dual filing" regime.

5. Over the last few months the Commission has refocused its enforcement resources on corporates and their licensed advisers, including sponsors. A tougher stance is being taken on three key failings - dishonesty, conflicts of interests and control/supervision failures that put investors at risk. The new SFO has enabled us to enforce more effectively by giving us a range of powerful and proportionate sanctions for misconduct, as well as broadening the permitted scope of our investigations. A number of corporate investigations are now underway, and we are working closely with other agencies, including the ICAC and the Police. Of course investigations are resource intensive, and take time. Our new powers under the SFO have only been available to us for just over seven months. There will therefore be some lead time before the results of our enforcement efforts become clear to the public. But the market should be left in no doubt that we will continue to concentrate our efforts against delinquent corporates and their financial advisers that damage investor interests and the reputation of Hong Kong.

6. The dual filing regime has also had a successful first few months. In these early stages of SFO implementation our work in reviewing IPO applications has had the greatest impact. Our involvement has not placed any additional burden on the market or lengthened the listing process. But our focus on substantive disclosure issues has identified problem cases where more work is required to give the public the information they need to make an informed investment decision. The statistics are illuminating. Out of 42 IPO applications from March to June we raised concerns on 16. In seven cases the problems were fixed. Of the remaining nine, six did not pursue their applications, and we indicated to the Exchange our intention to object to the listing of another two. The Exchange subsequently rejected both applications. One case remains under review. Our focus on whether prospectus disclosure "stacks up" is clearly having an impact.

The second area in which the SFC is involved is Priority II – "Tightening the Regulation of IPO Intermediaries"

7. As you all know, responses to the joint Exchange/SFC consultation on the regulatory regime for sponsors are now being considered. I need to explain that the consultation will lead first to recommendations being put to the Listing Committee for consideration. It is obviously too early to predict the full results of the consultation, nor outcome of Listing Committee deliberations. I would however like to emphasise that the Commission's primary interest is about competence and the quality of work. Corporate Finance Advisers are licensed by us and so they are directly our concern. We have seen too many cases where work done has fallen far below the expected standard, and some of these are now

under investigation as part of our refocused enforcement work. There is a need to articulate expected standards of due diligence and other aspects of advisory work so that competence can be assessed against accepted benchmarks.

8. I should however make clear that we are not expecting intermediaries to assume primary responsibility or liabilities rather than the issuers themselves. We are conscious that over-regulation can drive business away. We do not expect sponsors to step into the shoes of management. There seems to be a fairly widespread misconception about this, and taking the proposals forward we will address these concerns. We are however convinced that examples of poor quality professional work require sterner regulation or sanctions to ensure that Hong Kong matches international standards. We will work to ensure that the consultation achieves the appropriate balance of interests.

I should also mention Priority V – "Early implementation of SCCLR recommendations from the Phase I Corporate Governance review".

9. The SFC and the Administration issued a joint consultation on the SCCLR's proposals to empower the Commission to conduct derivative actions for minority shareholders. The consultation ended in July and a joint conclusion paper is due to be issued later this month.

10. In conclusion, I would like to emphasise that Hong Kong's corporate governance rules are about to undergo the most significant change in recent history, and will undoubtedly be world-class. Going forward it will be up to the community at large, and particularly our business leaders, to demonstrate their real commitment to good governance. This will be vital to ensure Hong Kong remains the premier Asian hub for international finance. The Commission pledges to work with the Administration, the HKEx and the corporate community to achieve this goal.

Thank you very much.