A RESPONSE TO THE CONSULTATION ON PROPOSALS TO ENHANCE THE REGULATION OF LISTING

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INTRODUCTION

On 3 October 2003 the Financial Services and Treasury Bureau ('FSTB') published a consultation paper to solicit views on how the existing regulatory structure as regards listing of companies on the Stock Exchange of Hong Kong may be improved taking cognizance of the need to "achieve a reasonable balance between market savvy and regulatory expertise".

My response to the consultation is summarised in the ensuing pages under four separate headings namely:

I. The Preferred Regulatory Model
II. Statutory Backing for Listing Rules
III. Statutory Sanctions
IV. Establishment of a Securities Court
V. Some General Comments

I. THE PREFERRED REGULATORY MODEL

The soundness of the rationale as advanced by the Expert Group to make the Securities and Futures Commission ('SFC') the front-line corporate regulator while leaving the Hong Kong Exchanges and Clearing ('HKEx') to operate as a purely commercial entity leads me to support its recommendation for the establishment of the Hong Kong Listing Authority ('HKAL') as a division of the SFC.

Although the consultation paper does not make any express reference to the HKAL it is evident that it is envisaged under the terms as outlined in Model A which key feature is the setting up of a division in the SFC to perform listing functions. This model has the distinct advantage of removing the ambiguities created under the three-tier system of regulation by setting a clear demarcation between the regulatory functions to be overseen by the SFC and the business functions to be assumed by the HKEx the latter of which includes the right to set market entry criteria as well as the responsibility for the maintenance of a trading platform upon which charges and/or fees may be imposed.

Despite the apparent smooth implementation of the 'dual filing' system since 1 April 2003 it must be viewed as merely a transitional arrangement since it fails to adequately address the fundamental issue of regulatory oversight. Nonetheless it should be acknowledged that the 'dual filing' system serves at least two important educational functions by (a) 'weaning' issuers and investors off the previous system in which the publicly listed HKEx oversaw the listing process and (b) enhancing the appreciation of the new regulatory system which will culminate with the establishment of the HKAL.

Viewed in this context it may be appropriate to consider an expansion of the 'dual filing' system as an interim measure whilst the necessary infrastructure for the HKAL is being finalised. However the foregoing is subject to one important caveat namely that there must be a definite time frame for the establishment of the HKAL to ensure a smooth transfer of the listing functions.

II. STATUTORY BACKING FOR LISTING RULES

An effective regulatory framework must be proactive with the objective being to strike an appropriate balance between the often-competing interests of protecting the investing public and allowing market forces to dictate the speed and direction of healthy competition and innovations. Regulators should therefore view their role as more of navigators as opposed to being watchdogs if they are to remain relevant in a constantly changing global environment.

To this end the balance between market savviness and regulatory expertise is perhaps best achieved with the adoption of the model as presently practised in the United Kingdom. This would in effect require the Legislative Council to delegate all rule-making functions as regards the securities markets in Hong Kong to the SFC so as to empower the SFC to make such timely and relevant rules as are required to enable it to statutorily discharge its regulatory objectives as prescribed by the Securities and Futures Ordinance.

The principal objective of the disclosure-based system of regulation is to facilitate the establishment of a more efficient and transparent securities market by (a) regulating the quality, accuracy, and timeliness of material information both during the initial public offering as well as throughout the tenure of these securities and (b) ensuring strict compliance with disclosure requirements through a combination of strengthened surveillance and enhanced enforcement.

To attain these targets the provisions of the 'Red Book' must be reviewed and revised with statutory backing accorded to the following key areas:

i. initial and continuous disclosure;
ii. duties of directors;
iii. duties of sponsors and independent financial advisers; and
iv. protection of minority shareholders

III. STATUTORY SANCTIONS

Given the inherent difficulties of successfully proving white-collar crimes the regulatory emphasis ought to be on the implementation of measures that will effectively minimize the occurrence of the same. In this regard a regime of civil and criminal sanctions should co-exist and the rule against double jeopardy should be removed.

The consultation paper suggests that the imposition of substantial financial penalties may in some cases violate the human rights of an individual. With due respect this view is overly restrictive and does not adequately reflect the complexities of the modern day securities markets. It is further respectfully submitted that better view would be that as advanced in Arjunan K. & Low C. K. in "*Powers of Investigation under Companies and Securities Legislation: A Hong Kong Perspective*" (1996) Australian Journal of Corporate Law 161 and "*Self-incrimination, Statutory Restrictions and the Hong Kong Bill of Rights*" [1995] Singapore Journal of Legal Studies 181 wherein the authors contend that such rights ought not be construed in an overly liberal fashion so as to undermine or jeopardise an established regulatory regime which has been implemented to maintain an orderly society.

Thus the validity of securities laws as well as statutorily backed listing rules should be upheld where it can be shown that they are proportionate to what was warranted by the nature of the evil against which they are directed. Although the SFC would shoulder the civil standard of proof on a preponderance of probability the threshold is not necessarily that high since the law must also consider the corresponding duty that a person has towards the community to which he or she belongs that would in turn necessitate the consideration of the obligations that are imposed under an established regulatory regime.

IV. ESTABLISHMENT OF A SECURITIES COURT

The pace of innovations in financial markets brought about by advances in information technology is such that often times the regulators are 'behind the curve' with their responses. This may be attributable in part to the constraints of the regulatory framework within which the regulator operates. An overly rigid regime premised on 'black letter law' may stifle market development and/or create loopholes which may be exploited by innovative lawyers while uncertainly may be the unintended by-product of a flexible regime that is 'principles based'.

While the enactment of the *Securities and Futures Ordinance* represents a significant milestone for securities regulation in Hong Kong it is very much a 'work in progress' for a number of its provisions remain to be judicially defined. It is therefore reasonably foreseeable that the SFC will be challenged on these provisions and with respect it remains to be seen whether the judiciary in its present form can rise to meet this challenge particularly in view of the rapidly changing landscape of securities markets.

As a proactive measure it is proposed that a specialised 'Securities Court' be established with an exclusive mandate to hear and determine securities law cases relatively quickly and efficiently by adopting civil procedures and to thereafter impose such sanctions as are necessary and appropriate. The principal functions of the Securities Court would be to perform an oversight function of the actions of the SFC and to assume an equally important role to combat the rise in the incidence of securities fraud.

To be effective the Securities Court must be empowered to issue a comprehensive range of orders to befit the breach of securities law. Provisions should be incorporated to facilitate it acting as an effective deterrent against market misconduct which is defined as encompassing all forms of activity which purpose is to disrupt the smooth functioning of the securities market. Enabling legislation should be enacted to permit findings of the Securities Court to be used by victims of market misconduct to seek compensation from those who are responsible for their losses namely the 'market manipulators' as a matter of right. This will allow victims of market misconduct to 'piggy-back' on decisions of the Securities Court where these involve a finding of liability on the part of the market manipulator.

The principal advantage of this proposal is that it would allow victims to sue the market manipulator as a matter of right in the civil courts where the Securities Court find the latter guilty whether civilly or criminally of any form of market misconduct. This would simultaneously reduce the onus of proof on the part of the victim while enhancing the burden of proof on part of the market manipulator. It is therefore envisaged that the framework would comprise two inter-related steps namely for:

a. the alleged victim to show that he or she traded in the securities and/or futures markets within the period which the alleged market misconduct is supposed to have taken place; and
b. the alleged market manipulator to thereafter adduce evidence to establish that he or she did not do the particular trade whether directly or through his or her agents.

As the case between the victim and the market manipulator is a civil matter the standard of proof would be that of a civil standard namely on the balance of probability on both the part of the alleged victim as well as the alleged market manipulator. The foregoing has its merits if based solely on the ground that it would reduce the costs of litigation since the alleged victim can 'piggy-back' on any finding of the Securities Court against an alleged market manipulator to discharge his or her evidentiary burden.

Time will always be of the essence for the determination of matters brought before the Securities Court given the fluidity of the capital markets and of financial instruments. As such the court must be mandated and compelled to operate within strict time limits and must determine matters before it as promptly as judicially possible having regard to the right of natural justice that must be accorded to the parties. Delays should not be condoned as the universal acceptance of the court will be decided by its ability to hand down definitive and sound judgments within a time frame that is much shorter than its counterparts within the court hierarchy.

However to prevent the Securities Court from being inundated by cases and thereby defeating one of its key objectives of handing down prompt decisions it is proposed that it only consider cases which meet two principal criteria:

i. the matter must involve securities law as defined in the applicable legislation; and
ii. one of the parties must be the SFC or the HKEx.

The second requirement is necessary as litigation between two individuals should best be classified as a civil matter to be determined in the customary manner. The ambit of the Securities Court extends primarily to issues pertaining to the governance of securities laws that is the interpretation of these laws and through them an assessment of the conduct of the regulators. Its jurisdiction therefore starts where the ambit of the present Process Review Panel concludes and it will consider the merits of cases in the same way as any other court.

To expedite the judicial process the Securities Court should also be empowered to order that certain matters be referred to arbitration particularly where these involve a degree of complexity beyond the resources of the court in terms of time. Although the arbitration proceedings are likely to be less formal there will be no compromise on the either the onus or the standard of proof that is required of the parties. The findings and recommendations of the arbitrator will then be submitted to the court which decision on the matter will be final. While this is a novel proposal and admittedly one that lends itself to being termed as 'sub-contracting by the judiciary' the potential benefits are evident. It provides for an infrastructure whereby acknowledged experts whose independence must be beyond reproach make preliminary assessments of the merits of complex cases without usurping the powers and responsibility of the court. The latter remains the final arbiter and would not be abdicating its judicial role as it must review the recommendations of the arbitrator, and thereafter provide reasons why it chose to accept, reject, amend or vary the same.

V. SOME GENERAL COMMENTS

This section of the paper may perhaps be termed the 'Wish List' going forward. At the outset, it is acknowledged that these issues were not specifically raised in the consultation paper and may indeed be outside of the scope of the same. Nonetheless I view these to be of sufficient importance to warrant closer and more detailed consideration whether as part of the present consultation and/or of another exercise if the objective is to establish a regulatory framework that meets the demands of the international investor as well as enhance the participation of the local investing community. In particular I believe that due consideration should be accorded to the six areas as outlined below namely:

a. Free float
b. Enhanced disclosure
c. Enforcement of regulations
d. Independent directors
e. Introduction of class actions
f. Establishment of a Shareholder Support Fund

As the foregoing are but preliminary ideas it will be necessary to develop them further since the ensuing paragraphs merely provide for an overview of the same.

a. Free Float

It is and always has been an anomaly that despite its standing as a leading international financial centre the free float of most publicly listed companies in Hong Kong remain relatively low by international standards. This is compounded by the high incidence of cross-shareholdings in many listed companies thereby effectively focusing control of corporate Hong Kong upon the hands of a few. While this may reflect an underlying cultural trend it does not contribute to the further development of the financial markets in the longer-term especially against a background of increasing globalisation. An increase in the size of the free float from its current levels would therefore be favourable although the final percentage will need to be arrived at after consultations with different parties. If pushed to state a number I would recommend that the minimum free float be lifted to at least 30 percent with an even higher free float of 50 percent for

smaller capitalised companies. This historical distinction should be gradually phased out with the higher free float of 50 percent being ultimately common for all publicly listed companies.

b. Enhanced Disclosure

'Chinese walls' have been instituted to prevent conflicts of interest between the various operating departments of securities firms, principally their research and trading divisions. If properly implemented it serves a useful function in minimising inter-divisional collusive actions that could potentially impede the efficient functioning of the price discovery system the hallmark of all capital markets. At the moment all that is required is a 'caution statement' to the effect that the securities firm may hold or trade the securities as recommended by its research department and that the investors should therefore exercise judgment in dealing with the recommendations. This practice may perhaps be improved upon namely by the imposition of a limited 'trading prohibition' in tandem with the existing requirement for disclosure. This would effectively mean that where a securities firm publishes a recommendation, the firm should ensure that it does not deal in the said securities on its own account at least three trading days before and after the publication. As such a requirement entails some degree of cooperation between the various departments of the securities firm there exists a risk that the requisite level of protection against potential conflicts of interest may be compromised. To this end it may be necessary to appoint a 'Compliance Officer' at a sufficiently senior level of management to ensure compliance with all aspects of the regulatory framework within which the firm operates.

c. Enforcement of Regulations

The judiciary plays a vital role in the smooth and efficient functioning of the capital markets by enforcing the laws and regulations that hold together the market infrastructure. However, there appears to be an apparent reluctance on the part of the judiciary to impose tough sanctions as provided for by the various ordinances. The judicial pronouncements in couple of examples that precede the enactment of the *Securities and Futures Ordinance* perhaps best illustrate this point. The then controlling shareholder of Hwa Tay Thai Limited disposed of a total of more than 330 million shares in the company representing some 16 percent of its issued capital without the requisite disclosure under the *Securities (Disclosure of Interests) Ordinance* and was fined only $18,000 for the offences. The perpetrator in South East Asia Wood Limited who was involved the creation of false markets for securities in breach of the *Securities Ordinance* ended up with a fine of $80,000 and was ordered to pay the Securities and Futures Commission $50,000 being

costs related to the investigation. The total sum of $130,000 is benign and casts substantial doubt over the willingness of the judiciary to impose strict sanctions in accordance with the provisions of the applicable ordinances. These decisions send out the wrong message to the market place and may impede the establishment of a level playing field. While it is perhaps unfair to highlight two cases to cast aspersions on the judiciary, it nonetheless serves to draw attention to the important issue of effective enforcement of laws and regulations as well as to provide further justification of the need to establish a Securities Court as outlined in Part IV above.

d. Independent Directors

This issue has surfaced on numerous occasions and the central question that is often asked is whether the independent director remains a myth in Hong Kong. Given the low free float and the tight control that majority shareholders exercise over the appointment of directors it is not uncommon for the 'independent' director to be less than fully independent for a variety of reasons. While the Listing Rules of the Stock Exchange of Hong Kong addresses some of these concerns largely from a view of the pecuniary interests this has proved largely ineffective since the rights of minority shareholders continue to be ignored. One cause for this could be that the independent director is either unable and/or unwilling to state the case for the minority shareholders. This is usually so because directors are voted in by the shareholders of the company at the general meeting in which the majority or controlling shareholder holds the key. By casting his or her vote in favour of a particular person or persons that shareholder can effectively dominate the composition of the board of directors which includes the independent directors. To preserve the notion of independence, it is proposed that the election of independent directors be limited to independent shareholders at general meetings. In addition it is further proposed that the percentage of independent directors should be at least a third of the composition of the board of directors so as to provide them with the opportunity to better represent the interests of the minority shareholders.

e. Introduction of Class Actions

It should be acknowledged that the individual investor is the best judge of his or her own interests and should therefore be deemed as the best placed person to decide whether or not to enforce his or her rights where these are impinged by the actions of the company and/or controlling shareholders. To this end reforms are urgently required to facilitate shareholder

activism and to empower shareholders if Hong Kong is to avoid the perception of being associated as 'risky' place in which to invest. The thrust of these reforms must be directed at the minimization and/or removal of legal impediments that prevent shareholders from the effective enforcement of their rights and would include enhancing the access to company information, removing obstacles for lawsuits, such as the statutory repeal of the rule in *Foss v Harbottle*, and allowing shareholder groups to 'piggy-back' on any adverse findings against companies and/or their directors. In short shareholders should be allowed to sue on instances of bad governance and the companies should be required to assist on the proviso that the rendering of such assistance does not materially compromise the interests of the company. Any action, reprimand or censure that are issued by the regulators and/or the stock exchanges against the company or its directors should be deemed as sufficient bona fide grounds for an action to be initiated and the onus would then fall upon the company or its directors to establish their innocence. While this may be viewed as a reversal of the onus of proof, its benefits as an important 'signaling' device should outweigh the costs.

To provide the necessary stimulus to encourage shareholder activism particular attention may be directed at two principal areas namely the introduction of class actions and the elimination of the 'loser pay' principle in civil litigation. Most markets in East Asia of which Hong Kong is an important part do not suffer from a lack of rules and regulations but rather from weak enforcement thereof. The *White Paper on Corporate Governance in Asia* issued by the Asian Roundtable on Corporate Governance in June 2003 recognizes this deficiency and recommended that 'all jurisdictions should strive for effective implementation and enforcement of corporate governance laws and regulations' as a key area of reform. In particular it observed that:

> 'The credibility – and utility – of a corporate governance framework rest on its enforceability. Securities commissions, stock exchanges and self-regulatory organizations with oversight responsibilities should therefore continue to devote their energies to implementation and enforcement of laws and regulations … In this regard, it is important to stress the interaction between effective market discipline and self-discipline. *The role of policy-makers is not only to enforce current laws but to promote institutions that facilitate market discipline*' (emphasis added)

Empowering shareholders to take legal action will compensate for the lack of enforcement. The success of capital markets depend in part on the ability of shareholders to enforce their fundamental private rights as investors and/or to seek recompense should these not be given effect to. Class action suits have a number of advantages over derivative action suits the latter of

which appears to be the preferred option for regulatory reform in East Asia. First it allows shareholders to file suits against directors with the burden of proof shifted to the latter. Secondly awards of damages are paid to the plaintiff shareholders rather than the company. Thirdly it avoids the expense associated with multiplicity as only one lawsuit is filed and the ruling applies to all shareholders that are subject to the same case unless he or she has opted out of the same. Fourthly it provides an incentive for shareholders to sue as the burden of legal costs is shared amongst the entire group rather than being borne by an individual. Lastly it provides a credible and effective threat to directors to ensure that they keep on the 'straight and narrow' as regards the affairs of the company. The establishment of the necessary legal infrastructure for class action lawsuits is not expected to be a major obstacle. For example it may be modeled after the system that exists for securities law litigation in the United States of America with such amendments as are necessary to reflect the specific requirements of the legal framework of countries in Hong Kong.

However unlike the practice in the United States I would not advocate the introduction of contingency fees at this juncture given the possibility of abusive litigation and the creation of an entirely new industry of 'professional plaintiffs'. In its place it is proposed that the 'loser pay' principle in civil litigation be dispensed with. This principle has been a major obstacle to the filing of shareholder suits in Hong Kong on two grounds. First there is an inherent worry by individual shareholders that they would be pursued to bankruptcy if they fail in their litigation against the company and/or its directors. This is so because defeat in civil proceedings not only exposes the shareholder to bear his or her own legal costs but also those of the party in whose favor the court has decided. This 'double or nothing' approach is compounded by the fact that the case may be taken on appeal should the company and/or the directors lose the verdict especially since their legal costs are usually borne either by the company itself and/or by the insurance company that has assumed the risk. Secondly companies and/or directors have been successful in thwarting shareholder suits by demanding security for costs under the applicable *Rules of the High Court*. This in essence requires the plaintiff shareholder to deposit into court such sums of money or security as is deemed appropriate in the circumstances to ensure that the 'loser pay' principle may be effected. While this is perfectly within the rights of the company and/or directors, it acts as an effective impediment since the shareholder may not be able to post the quantum as ordered by the court despite his or her having a reasonably good case at law against the defendants. The removal of this principle will contribute towards a level playing field between the plaintiff shareholders and the defendant company and/or directors within the arena of securities law litigation.

f. Establishment of a Shareholders Support Fund

The empowerment of shareholders contributes positively towards the enhancement of corporate governance. However the low free float of the shares of public listed companies in Hong Kong means that the interests of minority shareholders are sometimes compromised. These instances include transactions that are not in their favour or by precluding their participation from the same as evident by a series of recent corporate maneuvers where change in control were effected. The foregoing provides sound reasons for the establishment of a 'Shareholder Support Fund' in tandem with the introduction of class action suits which objective is to protect the interests of minority shareholders so as to enhance the standard of corporate governance in Hong Kong. The Fund may assist aggrieved shareholders in a number of ways such as the provision of advice and/or support in litigation against the company and/or its directors. To ensure the proper application of funds, charges will be imposed and support for litigation must be on a 'cost plus risk premium' recovery basis. The latter means that the Fund will share a part of the damages awarded by the court in a successful action by the minority shareholder. In addition investments in shares of companies should also be considered as this ensures the right of the Fund to attend general meetings and ask questions of directors. The precise mechanics and structure for the Fund will require further consultations with and input from the various stakeholders of the securities markets in Hong Kong and may be initially raised as an item for discussion within the Shareholders Group of the Securities and Futures Commission.