

The Asian Roundtable on Corporate Governance
The Relationship between Disclosure and Governance

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31st May 2000

Good morning, ladies and gentlemen,

A. Introduction

Hong Kong's securities and futures industry has developed significantly over the last decade. Hong Kong is well recognised as Asia's premier financial centre and as a significant player on the international stage. However, the global securities and futures industry is evolving rapidly and exchanges are facing increasing competition from each other and from independent trading systems which bypass traditional exchanges. As technology advances, the threats to the traditional exchange structure will only increase. Business will migrate to those markets with high transparency and liquidity, low costs of intermediation, diversified product base, sound regulation, high quality of service and robust infrastructure.

Increasingly, the power of markets will be determined by technology. The most liquid and high quality markets must practise good corporate governance and have critical mass of products, active participation of intermediaries and investors and sophisticated infrastructure.

Against this background, exchanges worldwide are rethinking their strategies and operations to improve culture of corporate governance and their services in order to optimise their performance in the securities and futures industry.

B. Corporate governance

Sound corporate governance practices and the need for greater transparency in the global financial markets are vital to national economic welfare and essential to maintain a stable global economic environment. However, while such goals of global financial transparency are being pursued as much as possible in a coordinated manner, the corporate governance objectives are faced with stumbling blocks.

Many observers perceive corporate governance to be a simple debate between those who protect rights of minority shareholder and those who believe that there are other corporate interests and objectives to be served. The phrase "corporate governance" and much of the related concepts reflect very different assumptions and create rather different images in the minds of different people and institutions. Such differences are often unrecognised and thus resulting in a very unsatisfactory context for progress. Many such differing perspectives on corporate governance arise from the wide variety of legal, cultural and commercial settings; there is no universally accepted standard of accountability for directors and officers towards companies, especially listed ones.

The term, corporate governance centres on "processes" designed to ensure that directors, controllers and managers of companies are held properly accountable to their shareholders. They must perform their duties with integrity and be subject to checks and balances which prevent abuse of power. It is also important that they must keep shareholders informed of matters affecting shareholder interests.

The main purpose of good corporate governance involves ensuring that the company management acts in the interest of all shareholders, including minority shareholders. The board of directors should adequately reflect and represent the interests of different shareholder groups. Corporate governance is intimately bound up with the business culture of a company, and this largely comes down from its top executives. One key process is the prompt and voluntary disclosure of information about the company's financial performance. Transactions involving the interests of directors, managers and controllers must be fair, and seen to be fair to other shareholders.

C. Systems of Corporate Governance

It may be said that primary market regulatory regimes fall on a spectrum ranging from merit-based to disclosure-based. No regime is pure. For example, every regime will set at least some basic requirements for public offering and listing - requirements which are of a merit nature. And even in the most merit-oriented regime a substantial amount of information will find its way into the market so that investors can make decisions for themselves, that is, disclosure, whether required or voluntary/inadvertent, still has a major role. Nonetheless there are very major differences in approach between different markets.

In a message delivered to the Congress proposing remedial legislation in 1933, US President Roosevelt stated that: "the federal government cannot and should not take actions which might be interpreted as approving or guaranteeing the newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit. There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public. This proposal adds to the ancient rule of caveat emptor, the further doctrine "let the seller also beware". It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and bring back public confidence."

The specific reasons advanced for disclosure and the purposes it serves include protection against fraud: promotion of public confidence in markets, raising of corporate standards, public interest in general and the promotion of investment analysis. Some have argued that the desirability of disclosure does not necessarily amount to the desirability of mandatory disclosure, and market forces would tend to produce acceptable securities disclosure without the intervention of the law. However, there are limitations on voluntary disclosure, as companies may not wish to make disclosures that may benefit their competitors or they may resist a common format of disclosure to facilitate comparison. Moreover, in the absence of legislation too little disclosure would be made due to its public good nature.

D. Hong Kong's Current Regime

Methods of ensuring effective corporate governance vary from places to places and countries to countries. Our system in Hong Kong grew out of the British system which relies on self-regulation through market self discipline and peer pressure to ensure compliance. Various non-statutory rules and codes of behaviour support our system of self-regulation.

The Stock Exchange of Hong Kong occupies a central position in our system of corporate governance. Prior to 1987, Hong Kong may be said to have quite a strong merit-based regulatory regime. The regime was relatively simple then. The rules in relation to listing of securities were not as sophisticated as current ones. Hong Kong's current primary market regulatory regime can be characterised as a hybrid, partly disclosure based and partly merit based system.

Our Listing Rules contain numerous provisions aimed at protecting investors, particularly the minority investors, from abuse, particularly the minority investors. Its essence is the establishment of processes to ensure that directors and controllers of companies are held properly accountable to their shareholders, that they are subject to checks and balances to prevent the abuse of power, and that

proper disclosure is made of matters affecting shareholder interests.

The main objectives of these rules are to ensure:-

- (1) that initial applicants for listing are suitable;
- (2) the marketing of securities is conducted in a fair and orderly manner;
- (3) investors are given sufficient information to make properly informed decisions;
- (4) investors receive proper ongoing disclosure; and above all,
- (5) all shareholders are treated equally and fairly.

The regime set out in the Stock Exchange's Listing Rules has a disclosure orientation. Issuers are required to disclose so that investors are given sufficient information to enable them to make a properly informed assessment of an issuer. The rules are also designed to ensure that investors and the public are kept fully informed by listed issuers of all factors that might affect their interests - and in particular that immediate disclosure is made of any information which might reasonably be expected to have a material effect on market activity in, and the prices of, listed securities.

Listing Rules of the Growth Enterprise Market (GEM) as we will speak about it later has a greater disclosure-based element. GEM listing applicants, unlike those of the Main Board, are not required to have a profit track record. However, they are required to disclose to investors Statements of Active Business Pursuits which provide both qualitative and quantitative information about the progress and achievements of relevant GEM listing applicants in the 24 months prior to listing in order to demonstrate active business pursuits that have taken place of that period. Further, GEM listing applicants shall provide investors with Statements of Business Objectives which set out their overall objectives and market potential covering the remainder of the financial year during which listing occurs and the two full financial years thereafter.

On the other hand, there are also certain merit elements in the regime, in particular, listings on the Main Board. The Listing Rules of the Main Board prescribe qualifying requirements for listing applicants. An applicant must have an adequate track record, meet profit requirements, have operated under substantially the same management for three years, have an open market in its securities, meet minimum size requirements, have at least two directors ordinarily resident in Hong Kong, etc. Most of these requirements are of a quantitative nature.

We have an array of other legislative and regulatory provisions designed to encourage or enforce good corporate governance. These include the Takeovers Code, the Securities Ordinance, the Securities (Disclosure of Interests) Ordinance, and the Securities (Insider Dealing) Ordinance. They are largely based on similar legislation and rules in the UK, Canada, Australia or the USA. Although time does not permit a description of all the provisions of these instruments, I think it would be appropriate for me at this juncture to mention that various corporate and securities legislation are undergoing reform in Hong Kong. The Government is actively considering changes to be made to the company law and a Securities and Futures Bill is now open to public consultation. I believe it is fair to say that collectively our regulatory framework affords a first world investor protection.

E. Initiatives of the Stock Exchange

Since 1992, we have convened five Corporate Governance Working Groups to examine and consider corporate governance issues and its related developments in Hong Kong and elsewhere so as to bring us in line with countries such as the U. S. and the U.K. Over the past eight years, we have introduced measures to improve the corporate governance of Hong Kong listed companies with the aim of enhancing greater disclosure and transparency for the securities market and improving accountability of directors and officers of listed companies in Hong Kong.

To this end, our 1993 Code of Best Practice of the Main Board sought to increase the accountability of directors to shareholders; and to improve shareholders' access to information. It also affirmed the rights of the two independent directors as full members of the board, and gave guidance on their role.

The Code was incorporated as an appendix to the Listing Rules of the Main Board and has been regularly updated to include rules on the disclosure of directors' emoluments and senior management compensation.

Since 1996, all interim and annual reports were required to include a statement affirming compliance with the Code – and explain the reasons for any non-compliance. The most recent addition to the Code was a guideline on formation of audit committees by listed companies.

The principle of good corporate governance is particularly important for our Growth Enterprise Market (GEM) launched in last quarter of 1998. Indeed, because we have adopted a more disclosure-based regulatory regime for GEM, good corporate governance is arguably even more important than those on the Main Board. Under such a more disclosure-based regulatory philosophy, companies listed on our GEM need to observe the strict disclosure requirements. Such companies must comply with the corporate governance requirements by appointing independent non-executive directors, qualified accountant and compliance officer to the GEM companies and, further, establishing an audit committee is a prerequisite.

Obviously, rules need to be backed up by effective enforcement – particularly as we move more towards a disclosure-based regulatory regime, in place of the traditional merit-based approach. It is important that directors who are tempted to abuse the trust of investors should see that this is likely to involve serious consequences for them personally. The Stock Exchange as a regulator will enforce disclosure and take tough disciplinary action where breaches occur.

F. The Way Forward

As mentioned earlier, the Stock Exchange's investor protection regime is moving away from a merit-based system, where regulators make judgements about the quality of listing candidates. Instead, we are moving towards a disclosure-based regulatory philosophy where full, fair and accurate information and descriptions of the facts are provided to investors under strict rules. Investors are empowered with timely and detailed information to make their own investment decisions. They must also be kept informed of any circumstances that are likely to affect the value of their investments. All these will also be better achieved by technological advancements in the area of securities regulation in Hong Kong.

We strongly believe that disclosure can promote good corporate governance. It is the aim of the Stock Exchange that:-

- investors in Hong Kong have maximum access to investment opportunities;
- investors can make informed decisions;
- real time relevant information of listed issuers are always available in the securities market; and
- since all parties have clear roles and clear incentives, including rewards and punishments, to perform those roles, all participants, such as, investors, advisers, issuers and regulators, can better plan their strategies; the overall outcome should be more optimal and thus making the market more efficient.

We will, however, continue to improve and up-date the rules and their enforcement. We go to some pains to convince directors and market practitioners that corporate governance is not some theoretical religion invented by accountants, lawyers or regulators, but an essential way of life for the directors and managers of listed companies, with very practical consequences both for their companies and for our market as a whole. These are decisive steps leading to the strengthening of Hong Kong's regulatory framework.

G. Conclusion

In summary then, good corporate governance remains the most effective means of investor protection. The empowerment of investors with information enables them to decide whether the risk profile of a listed company is within an acceptable level.

The quality of corporate governance can also affect the economy as a whole. The price of a company's shares in the secondary market is also profoundly affected by investors' perception of the quality of its corporate governance. Good corporate governance is really no more than enlightened self interest. It lies at the core of capital formation as the issuer's state of corporate governance affects the willingness of investors or lenders to entrust their savings to company management.

If a stock market acquires a reputation for listing companies with questionable governance credentials, investors will avoid it. It is a matter of international record that companies with a consistent record of good governance find it easier to raise capital, including having to pay a lower cost of capital; otherwise, it can affect the ability of even well-governed companies in that market to raise capital. Such companies are also able to do so on more favourable terms than companies with a history or mistreating minority shareholders, failing to disclose important information, or of bad governance generally. Short term benefits resulting from taking advantages of shareholders may appear attractive to some short-sighted managers. But these advantages cannot be sustained in the long term. Over time, high corporate governance standards create greater wealth both for the company involved and for society as a whole.

I believe we have a well-developed corporate governance regime in Hong Kong. Listed companies, investors and shareholders in Hong Kong are generally aware of corporate governance issues but there are still rooms for improvement. In an economy like Hong Kong which depends to a substantial extent on its position as an international financial centre, the perceived integrity of the securities market is particularly important. Damage to the market's reputation through persistent cases of bad corporate governance affects the development of the securities industry as a whole, as thus affects the wealth-creation process more widely. In this regard, we are confident that listed companies in Hong Kong understand the importance of good corporate governance and in order to maintain its competitiveness and attractiveness in fund raising, to continue to improve their standards in this area by constantly offering full, frank and timely disclosure of corporate information to its investors and shareholders in Hong Kong and elsewhere.

Thank you.