

KPMG “Leaders of our Community” Luncheon Talk Series

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Opening

Good afternoon, ladies and gentlemen!

I am delighted to be back at KPMG and to speak at your "Leader of our Community" luncheon talk. This is actually the first time since I have retired from the firm, almost two years now, that I speak at one of your events. It was Ayesha who invited me and if you know Ayesha, she never takes “No” for an answer!

As you know, I have kept myself busy since my retirement, trying my hands on different areas of interest such as education and sports and now as a regulator.

People often asked me what it is like to be with the SFC. Well, it is almost like being back at KPMG because the two organisations are in some ways quite similar, not to mention that there are many ex-KPMG staff working there. It has a strong corporate culture with excellent people who are dedicated to their course, hard working and continuously driving for a high standard in what they do.

After I took up the chairmanship of the SFC five months ago, I set out to gain a better understanding of how the regulator works, what our stakeholders think of us and the challenges we face.

So, I would like to share with you some of these challenges today and talk a bit more about two particular areas which may be of interest to you and my vision for the future.

Challenges ahead

So, what are some of the key challenges facing us?

1. Cross border regulations

Governments from the developed world responded to the global financial crisis by overhauling financial regulation with a focus on global co-operation and global convergence. Whilst the reform should strengthen the resilience of the global financial system, there is a risk of a "one-size-fits-all" solution without adequate regard to the different sophistication of local regulatory systems and the maturity of economic and financial development.



In fact, some of the legislation and rules formulated in the West have far-reaching extraterritorial effect on foreign jurisdictions. Therefore it is important for Asian regulators to stick together to ensure that those changes which do not work in our markets are not imposed on us.

2. Relationship with the Mainland

Recently, some Mainland privately owned enterprises listed in Hong Kong have reported deteriorating results not too long after their listing. Therefore, another cross-border regulation issue concerns access to information, especially access to auditors' working papers, which has recently become a burning issue. It is not appropriate to comment in detail on the ongoing proceedings against Ernst & Young over access to audit working papers (the case is scheduled for hearing starting on 27 March) but in general terms I can say that it is important that the SFC and auditors are able to discuss issues that may arise from the audits of listed companies in Hong Kong especially if there are issues that may affect the integrity of the market for shares in a listed company.

Whilst the auditor is often likened to a watchdog rather than a bloodhound, I would like to describe the SFC as more like a bloodhound and the regulatory framework presumes that the watchdog auditor will be able to put the bloodhound regulator on the scent. To do this, auditors must be able to discuss matters they come across and/or issues that the regulator comes across, and sometimes that must involve disclosing matters contained within the audit working papers.

This is a little different from the issue that has arisen in the US where the spotlight has recently focused on non-US audit firms located on the Mainland. This raises a significant cross-jurisdictional issue because it involves Mainland firms and a foreign regulator. In contrast, the question here in Hong Kong concerns Hong Kong firms and the application of our law in Hong Kong.

3. Battling with short-termism

The lessons of the financial crisis are fading, which poses a common problem for regulators around the world. How do we remind corporations, investors and intermediaries to avoid focusing on short-term gains, and instead adopt approaches which achieve long-term returns? When the market is good, people just want to do more business and they think regulators are in their way. When the market is bad, regulators should not pull everything to a halt. Where do we draw the balance between protection of investors and short-term profitability and does the market give enough credit to good corporate governance and business ethics?

As part of the drive to strengthen the quality of our financial markets and to implement certain global reforms, there are a number of key changes this year such as the new Price Sensitive Information (PSI) Regime and the reform of the regulation of IPO sponsors, which I will talk more about in a minute.

There is also the G20 reform for OTC derivatives regulation – in fact KPMG has been working with the SFC to develop the financial resources rules under the new regulatory regime.



Other areas where we are looking at include the regulation of high frequency trading, operation of dark pools, sale and disclosure requirements of investment-linked assurance schemes or what we call ILAS, development of a scripless market, review of the professional investor regime and the overall reform of prospectuses legislation.

And the list goes on!

New PSI regime

I would now like to spend a bit more time on the new Price Sensitive Information or Inside Information Regime, which became law and came into effect on the first day of 2013. So what does the law say?

Basically inside information refers to information not generally available to the investing public, but once becomes public knowledge could materially affect the share price of a listed company and a listed corporation must disclose “inside information” as soon as reasonably practicable unless one of the safe harbours applies.

A key objective of the PSI regime is to cultivate a disclosure culture by listed companies, which unfortunately has been lacking in Hong Kong. We note that the number of announcements concerning inside information has increased since the new law took effect. In January alone, listed companies made 401 announcements related to inside information, an increase of 87% year on year. The numbers speak for themselves – listed companies are working towards more disclosure.

What has the SFC done to help with compliance?

To assist compliance with the new law, we have issued guidelines to explain how the provisions operate. The guidelines have quoted precedents from the tribunals to illustrate the key elements that constitute inside information and include examples to help companies to be aware of the pitfalls. They also include pointers to show companies how to set up internal controls and procedures.

In December, more than 1,700 participants from Hong Kong, Shanghai and Beijing attended the seminars jointly organised by the SFC and Stock Exchange of Hong Kong to help them better understand what is required under the new law.

We have also started an enquiries hotline from 1 December 2012 on interpretation and application of the provisions. Up to the end of January, we have received some 50 calls covering a range of questions which can be summarised into six broad areas:

1. Where can I find the guidelines on the SFC website?
2. The definition and interpretation of inside information which I just explained – indeed, it's not a new concept.
3. I mentioned safe harbours earlier – these refer to specific circumstances permitting a corporation to withhold the disclosure of inside information. We wish to strike a balance between encouraging timely disclosure of inside information and preventing premature disclosure which might prejudice a corporation's legitimate interests.



The five safe harbours are:

- the prohibition of disclosure under Hong Kong laws,
- incomplete negotiations or proposals,
- trade secrets,
- liquidity support to banks by the Exchange Fund, and
- disclosure waived by the SFC if a disclosure is prohibited by foreign laws.

Except for the first safe harbour -- prohibition of disclosure under Hong Kong laws -- listed companies must maintain confidentiality before they can rely on these safe harbours.

4. Timeliness of disclosure and preservation of confidentiality - under the new regime, companies are permitted to take all steps that are necessary in the circumstances prior to making disclosure, such as ascertaining sufficient details, internal assessment and verification of facts.

However, strict confidentiality must be maintained prior to the publication of inside information and if the corporation believes that confidentiality cannot be maintained then they should consider publishing a preliminary announcement or a holding statement.

For example, a company enters into a very substantial transaction which is subsequently ruled by HKEx as a reverse takeover and hence is required to comply with all new listing requirements. As a full announcement cannot be made sooner, the company should consider issuing a preliminary announcement, including the terms of the transaction, HKEx's ruling and the company's proposed course of action. And a company may apply for a suspension of trading of its shares pending a full announcement.

A question was asked as to whether a company will be in breach if an announcement cannot be made promptly because it is being vetted by the regulator! Well, I can assure you that we will be very sensible in handling such a situation should it arise. However, if a company submits a draft announcement which is materially deficient or there is undue delay in responding to regulatory comments and therefore the disclosures, then in these circumstances, we may take enforcement action.

5. Profit warning or positive profit alert - this is an area where there is probably room for improvement. We would like companies to avoid using standard, boilerplate language when making such an announcement and I have a few examples:
 - A company announced that it expected to record a loss for 2012 and attributed the loss to a drop in turnover. Clearly in this example the company should disclose also the reason for the drop and estimate the magnitude of the loss. An announcement that lacks substantive information really defeats the purpose of disclosure.
 - In another case, a company announced that it expected to incur a significant loss in 2012 due to bad investment decisions including early redemption of bonds, but without providing the estimated quantum of individual items. Again, we followed up with the company which then issued an itemised account of the losses.



- In another extreme case, a company's information in the announcement didn't even tally. The company in question expected profit for 2012 would decrease by over 50% compared to the profit of RMB1 billion last year, but then in the same announcement added that 2012 profit would range between zero and RMB50 million. Clearly, either the profit would decrease by 50% or the profit ceiling of RMB 50 million was flawed. The statement was later rectified by the company to clarify that it's expecting a profit decline of over 90%.
6. Liability in relation to a breach and internal controls. What I do want to point out is that when considering whether an officer has taken all "reasonable measures" or has acted intentionally, recklessly or negligently, the SFC will take into account the roles and responsibilities of the officer concerned. In case of a breach by a company, if proper internal controls are in place, and the officer concerned has acted in good faith and in accordance with his fiduciary duties, and has no actual knowledge of the information or involvement in the breach, the officer is unlikely to be personally liable under the law.

So I am saying, dial the SFC's hotline if in doubt but don't expect us to decide for you what qualifies as price sensitive information. We're just drawing your attention to the types of questions that you should be asking yourselves. My suggestion would be: If in doubt, publish it!

A note about ORA

I also want to use this opportunity to talk about overseas regulatory announcements (ORAs), a designated category of announcements on the HKEx website by dually-listed companies to fulfil their overseas regulatory requirement.

Although over 20% of announcements are actually categorised as ORAs, investors pay little attention to them because they're often administrative in substance – such as a notice of a directors' meeting, issued by Chinese companies according to the Mainland regulations.

HKEx has allowed companies to publish ORAs either in English or Chinese, or both languages, although less than 1% of ORAs are issued in both languages.

Some ORAs, however, contain price sensitive information such as preliminary results, or information on asset impairments or revaluations, litigation, reversal of a bad debt provision, and changes in accounting treatment, etc. We wish to remind all dual-listed companies to carefully consider whether the information in an ORA constitutes inside information, and, if so, to ensure they comply with the law and make proper disclosure.

How do we monitor disclosure?

All along, we have worked with HKEx to minimise overlap between the new statutory regime and the Listing Rules. As a result, HKEx has removed the reference to price sensitive information from the Listing Rules. There's also close co-operation between SFC and HKEx in monitoring disclosure, press articles and share trading of listed companies. The SFC might contact the companies in question to raise issues or give guidance where there are disclosure inadequacies or anomalies.



However, under the new regime, HKEx remains the front-line regulator to ask listed companies about unusual trading movements or when price sensitive information has been leaked to the press before a company announcement is made. HKEx can require the company concerned to make an announcement or halt trading.

If HKEx becomes aware of a possible breach of inside information provisions, it will refer the matter to the SFC. Now that there is statutory backing for corporate disclosure, the SFC is the enforcer where there is a breach.

Regulation of IPO sponsors

Now I'll talk about the regulation of IPO sponsors. When I was an auditor, I knew the dilemma that auditors often found themselves in – when the market is good, everybody wants to go for a listing. Auditors who want to uphold a high standard will be confronted by their clients with questions like “How come other auditors say ‘yes’ and you say ‘no’?” I can imagine sponsors facing the same problem. But we are equally concerned that the standards of sponsor work have fallen short of reasonable expectations.

To address these concerns, we issued a consultation paper last year on proposals to provide a regulatory basis for defining the expected quality of sponsor work which is in the interests of public investors and indeed all stock market participants. The conclusions of the consultation were published in December last year and the new requirements will apply to listing applications from October this year.

The key changes include:

- a. publishing of the bilingual advanced draft prospectus on the HKEx website as soon as it's received by the Stock Exchange and before the Exchange starts to look at the document.

Furthermore, if after an initial review by the Exchange a document is returned because it's not “substantially complete”, the document will remain on the website. And the fact that it's returned will also be published. If a document is not immediately returned but is subsequently rejected by the Exchange during the commenting process the document will also remain on the website.

The idea is to encourage sponsors and listing applicants to submit a quality first draft. Initially, successive amended drafts, regulators' comments and applicants' responses will not be published although we will reassess this position;
- b. clarifying sponsors' responsibilities over due diligence work and experts' report. A sponsor is not expected to re-perform the work of an expert but it should ensure that the scope of the expert's work adequately covers the reliability of the information provided to the expert;
- c. requirement that a listing applicant formally appoints a sponsor at least two months before a listing application;
- d. clarifying sponsors' liability under the Companies Ordinance although this will require legislative changes; and
- e. streamlining of the listing process by HKEx's Listing Division and clarifying what information must be submitted. Since the consultation conclusions were released, the SFC and the Stock Exchange have been working closely on measures to streamline the regulatory commenting process so that companies can be listed more efficiently.



My Vision

I've talked about the challenges we face and highlighted our work in two key initiatives. So I will now elaborate on my vision for the SFC and indeed the future of the Hong Kong financial markets.

Hong Kong has a reputation as the freest economy enjoying both free capital and information flows, benefiting from strong institutions that uphold the rule of law and protect property rights. It is this institutional structure that provides certainty and predictability to investors around the world, including Mainland China, and underpins our success as an international financial centre.

My vision for the SFC is:

1. First and foremost, to protect investors. We will continue to uphold a quality market by enforcing a sound regulatory framework through effective surveillance and in the last resort, enforcement. One of the key elements of a quality market is fairness and justice, which means that wrongdoers are punished and investors are adequately compensated for losses due to market fraud and misconduct.

In particular, we'll pursue criminal sanctions whenever we can. This has proved a very effective approach which we'll continue. And we may take more cases to court as a result. However, I want to stress that in respect of criminal prosecution, the priority should not be in the time needed in the legal process but rather the goal we are trying to achieve. This is to send out a clear deterrent message to the market that there's a huge price to pay in an offence.
2. We should also proactively promote the education of investors through our subsidiary, the Investor Education Centre, to help people better equip themselves to make informed financial decisions and to manage their money wisely. A knowledgeable and educated investor is the best defence against market malpractice and fraud.
3. For listed companies, in addition to encouraging good corporate governance, I would like to see more effective independent non-executive directors (INEDs). I am sure that many INEDs take their responsibility very seriously but unfortunately there are still those who merely rubber-stamp what is put forward by management. I would also like to see more diversity on the boards of listed companies, especially more women on boards!
4. We will continue to implement and adopt global financial regulatory reforms but try to make adaptations to suit the uniqueness of Hong Kong's securities markets through our involvement in the International Organization of Securities Commissions and other global regulatory bodies.
5. The profile of the players in Hong Kong's securities and futures industry is quite unique with a combination of international, local and an increasing number of Mainland players. With this profile, Hong Kong is well positioned to become a wealth and asset management centre – the SFC has a key role to play in this regard. To achieve this, we will collaborate more closely with the Financial Services and the Treasury Bureau, key industry associations and market participants. We are currently looking into enhancing the legal and regulatory regime for investment fund vehicles. While we facilitate market development and expansion of product choices, we will not compromise investor protection in the process.



6. Last but not least, we will proactively engage with our stakeholders by means of consultations, seminars and close dialogue and will work closely with other regulators to close any regulatory gaps.

Closing

Our commitment lies in the overriding mission of the SFC to protect investors and to ensure that markets are fair, efficient, orderly, internationally attractive and sustainable. We promise to continue to uphold regulatory standards and resist regulatory arbitrage. The SFC's commitment to promote transparency and market efficiency is simple: we don't compromise our standards!

Whether we like it or not, there will always be diverging interests and views on the functioning and future direction of our financial markets. Very often, our challenge is to find the balance between the various interests. We will therefore always establish the facts, listen to our stakeholders, and carry out a thorough analysis before making any final decisions. It is most important that the SFC remains independent and acts in the best interests of the investing public and maintains the stability, quality and development of Hong Kong as a world-class financial centre.

In closing, I just want to say that instead of having a plethora (pages and pages) of rules and regulations and the toughest enforcement regime, I would much rather see the market regulate itself. I therefore look forward to the day when all market players practise strong business ethics, pursue long-term sustainable profits instead of short-term gains and invest in the future of our community.

I will then be out of a job!

Thank you.