

Disclosure Regulation: The Role of Intermediaries¹

Keynote Address

By

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1. Good morning, ladies and gentlemen. I would like to thank James Burden for inviting me to speak at this Asia Pacific In-House Counsel Summit. To those of you visiting from around the region or elsewhere, welcome to Hong Kong.
2. Before I start, I have a piece of disclosure to make. All opinions I express here are personal and not necessarily those of the Commission.

Introduction

3. You have had a full day yesterday discussing the compliance function, the impact of Sarbanes-Oxley and corporate governance in general. Last week, I came across this marketing quote which I thought was very insightful: “People don’t buy a product: they buy a promise²”. As a lawyer or issuer, you offer a service or product that must contain a promise of quality. This must be true of securities markets, as in all other markets. You prefer one product or market to another because of the promise of quality – if the investor or consumer is disappointed, he or she will simply go to another product, producer or market.
4. We sometimes call this promise “confidence”. Issuers that tap public capital offer a promise of a share in the future business of the issuer based on continuing trust. Similarly, all lawyers, accountants, investment banks, brokers and sponsors, including regulators, have a relationship of trust with investors. This relationship is not

¹ I am grateful to Ashley Alder, Laurence Li and various colleagues at the Commission for helpful research and comments in drafting this paper. All opinions and errors and omissions are my personal responsibility.

² Alexa Fasse, PC World, March 2004

necessarily as direct as that of the issuer, but recent litigation and prosecution of intermediaries selling problem stocks, bonds and derivatives indicate that the public is increasingly focusing on its real meaning and value.

5. During the height of the technology bubble, when intermediaries and other gatekeepers realized that new technology companies had very short histories based on intangible value propositions that did not "fit in" with the normal objective evaluation framework, there was a shift away from "merit-based regulation" towards disclosure-based regulation. Merit-based regulation places some onus on the approval authority of public issues of securities to judge the suitability for public investors of the security offered or traded. Disclosure-based means that the gatekeeper avoids making such a merit judgment and all risk is placed on the investor on the basis of full disclosure. This "caveat emptor" approach clearly has much to recommend it in ensuring investors take responsibility for their own, informed decisions. But after the failure of many Internet companies when high-growth promises became spectacular crashes, even the merits of disclosure-based regulation have come under scrutiny.
6. Today I would like to explore the meaning of disclosure regulation and the role of intermediaries in the securities markets.
7. Information is a market fundamental. By and large, small investors cannot control or even influence the management of a company they invest in, but they should be entitled to the material, accurate, complete and timely information to judge whether to invest or divest in a particular company. Such disclosure enables public accountability. In the old Chinese saying, watch what I do, not what I say [聽其言，觀其行]。 Plainly speaking, disclosure is only a promise, but deeds or action fulfils or reneges on that promise.
8. So what is all the fuss about disclosure regulation? As lawyers well know, the devil is in the detail. It is easy to say a company should provide "full disclosure" and "all the information". But what is "full disclosure" in practice? Are disclaimers a kind of disclosure? Is full disclosure of bad information good disclosure? What about missing or misleading information? Where does full disclosure end and merit judgment begin?

9. These are not theoretical questions. The market and my colleagues face them everyday. In this our regulatory approach must be practical. It must recognize and be sophisticated enough to deal with the real business world in which these questions arise.

Disclosure means Quality Disclosure

10. We must always bear in mind that disclosure is there to help investors. It has to enable investors to understand enough about a company and the securities so that they can make their own informed decisions. Disclosure is not about disclaimers and pages of boilerplate "risk factors" used in such a way as to limit the responsibilities of the issuer or its advisers and intermediaries to give investors the full picture. One cannot seek to access public capital on an effectively blank piece of paper that "discloses", albeit truthfully, there to be no business, no plans, and no assurance of management commitment.
11. Disclosure-based regulation does not imply a simple, neat trick whereby all risks are passed to the investor. The investor judges the quality of a company through the quality of information disclosed, the reputation of the issuer, and in the absence of a track record of that issuer, the quality of the intermediaries that assist in bringing that issuer to market. It is that "derivative" quality assurance that is being tested in the courts of world opinion today.
12. Disclosure is the means and not an end in itself. The end is a high quality market, with high quality information disclosure and where there is a high level of investor confidence in the quality of the due diligence and ethics of those who bring corporations and their securities to market. Disclosure works only "if the information disclosed is : -
 - Reliable;
 - Consistent with economic reality;
 - Comprehensible;
 - Informative of risk profiles and risk management;
 - Descriptive of valuation practices; and
 - Consistent with generally accepted accounting practices³".

³ Group of Thirty, "Enhancing Public Confidence in Financial Report", Washington, DC, December 2003

In addition, disclosure only works if market discipline works, that is, markets and regulators can and will punish those that do not practise full and meaningful disclosure.

13. For disclosure to be meaningful, dry facts must be explained and placed in a context. The full picture is more important than each individual stroke of paint.
14. Let me illustrate my point with a few examples. If a company discloses that it has higher debtors' turnover than other comparable companies, it must explain this in terms of its distribution network or special characteristics. If it has substantial sales to overseas markets, a claim that it does not know the ultimate customers and deals only with import/export agents would appear hard to understand. These were actual cases. Many of you as corporate lawyers will appreciate why my colleagues insisted on further disclosure in our Dual Filing work.
15. In Hong Kong we face a special challenge. More and more companies with Mainland businesses are getting listed here. This is our advantage as well as our risk. Aspects of the Mainland environment and evolving business practices are not easy for outsiders to understand and evaluate. One example is the use of import/export agents as I mentioned earlier. Another often-seen practice is cross-guarantees among supposedly unrelated parties, which might or might not be legitimate.
16. Indeed, one of the key risk elements in all developing or rapidly evolving markets, including the Mainland, is that businesses operate in environments where property rights are not necessarily clear nor protected in the same manner as in the common law regime in Hong Kong. Title deeds are not "full ownership" if land use can be revoked administratively or caveats and liens are not always transparent. There is often a complicated restructuring exercise before the assets are "more clearly owned" by the corporate group to be listed. Indeed, companies list in Hong Kong in order to take advantage of the relative certainties in Hong Kong such as our legal infrastructure governing commercial transactions.
17. But it does make the task of all intermediaries who assist in that process to perform the due diligence necessary to understand, disclose and explain such complex risks. Confidence in market or product

quality cannot be enhanced if everyone hides behind the “full disclosure” façade. Each intermediary must demonstrate what they did to earn their fee – the lending of their name to a product, that they fulfilled their duty to conduct their work honestly, independently and with due diligence and with regard to due process.

18. Getting quality disclosure about these Mainland businesses is key to Hong Kong’s success. This is the true meaning of Hong Kong as a knowledge-based economy. By providing investors useful information, we help them evaluate risks and opportunities. They would, in turn, feel more comfortable making their investments through our market. The quality of our market is only as good as the quality of disclosure available here.

Disclosure Regulation requires Credible Enforcement

19. To sum up, disclosure regulation works because it facilitates market discipline, but as former ASIC Chairman Alan Cameron recently said in his brilliant paper, we “do need to understand its full ramifications – namely, that the credible threat of enforcement is needed to ensure that such a system works – and that is the hard part.”⁴
20. What this means is that those who supply that information – the issuer, the lawyers, auditors, sponsors, investment bankers, brokers and others involved in bringing an issue to market – have both responsibility and liability in ensuring that the quality of information disclosure not only meets the objectives and criteria of disclosure set out above, but also meets all the rules and regulations governing such conduct. And if they fail in such duties, there should be a credible set of sanctions that proportionately punishes them for such failures.
21. This explains why Dual Filing was introduced, so that the statutory regulator, the Commission, could participate in the listing process with the backing of legally-backed enforcement powers. As the recent Government Consultation Paper on Listing Regulation⁵ pointed

⁴ Cameron, Alan, “Supervision at the Micro Level: Do Disclosure-Based Regimes Work?”, (Ed): Litan, Robert E, Pomerleano, Michael, Sundararajan, V., *The Future of Domestic Capital Markets in Developing Countries*, Brookings Institution Press, Washington DC, April 2003, available at <http://www.worldbank.org/wbi/banking/finsecpolicy/domestic2003/agenda.html>

⁵ Expert Group, “Report of the Expert Group to Review the Operation of the Securities and Futures Market Regulatory Structure”, Hong Kong, March 2003, available at www.info.gov.hk/info/expert/expertreport-e.htm

out, Dual Filing is an improvement over the past regime, but it still has significant gaps.

22. But even within its limitations "Dual Filing" has worked because the Commission has not and will not pass judgment on investment value or whether a company is "good enough" to be listed. But we would make comments to ensure investors get all the important information. We also pose a credible threat to those who supply information that is misleading or false; this now risks serious consequences. This is what disclosure regulation is all about.
23. The alternative would be to conduct disclosure regulation as a mechanical exercise. As long as a document deals with all the items on the relevant checklists, it would be deemed sufficient. Many issues would then be dealt with by the inclusion of warning statements and a lengthy and largely meaningless Risk Factors section. This approach misses what is most important to investors and encourages misleading disclosure. It is not how disclosure regulation is practised in sophisticated markets.

Focus on Back-end Enforcement, not Front-end Vetting

24. Disclosure regulation is only as effective as the liability that companies, directors, and their advisers have to bear for breaching the requirements. Moreover, the liability has to outweigh the potential gain from misconduct. In this respect, there are two critical elements: (i) the regulator's ability to investigate and gather evidence and (ii) the availability of sanctions that carry effective deterrence. Both imply that disclosure requirements must themselves carry some degree of statutory force.
25. A well-functioning disclosure regime also means a lighter regulatory burden on those companies and market participants who behave well. Hong Kong's disclosure regulation at present focuses too much on pre-vetting of documents, leading to delays and tension in the process. Worse still, it can lead to poor preparation on the part of companies and their advisers, since pre-vetting is taken as a sort of negotiation and drafting process in which the regulator is a participant, or sometimes leads to less disclosure (to avoid prompting the regulator to raise more queries). This is bad for market participants and, in any event, doesn't adequately protect investors.

26. This is why the debate over whether the HKEx or SFC should carry out the listing function focuses on the wrong question. The right question is not who approves the listing of securities, but how the regulatory regime in totality, the regulators as well as the market professionals, should operate to improve the quality of our markets. We want a regime where the majority of companies and market professionals who play by the rules and play fair with investors face a light compliance burden. But those who break the rules will face serious sanctions.
27. We are delighted that there is wide consensus that important listing rules need statutory backing to make enforcement credible. As our Financial Secretary said in his Budget Speech, the Government will be introducing the legislative amendments early next year. We believe our collective regulatory regime's next improvement would be in strengthening enforcement and reducing process.
28. In short, it is not important to the Commission as to who does what, but in improving the way we all work together to improve the quality of our markets.

Market Professionals are also Gatekeepers

29. The second reason why we need to move away from the present emphasis on front-end vetting is that market professionals assume rightly or wrongly, that after they satisfy all questions, they have no more liability in the process.
30. My good friend, David Brown, Chairman of the Ontario Securities Commission recently perceptively posed corporate governance as three key elements of checks and balances: ethics, process and structure. What we need to ask as regulators is how in recent years, deliberate corporate fraud and misconduct has been perpetrated despite all three layers of checks and balances.
31. It is true that we cannot legislate good ethics. But if for some reason, the ethics of the issuer are bad, and the professionals assist in such bad behaviour, then they must be accountable to the public through proper sanctions. In other words, bad apples should not smell good. And good professionals should not help bad apples smell good.

32. I come now to the role of market professionals in the disclosure regulation regime.
33. Companies are experts in their own fields. But since they are unlikely to be familiar with the codes of conduct and complex securities rules and legislation, including compliance with disclosure standards, they rely on their professional advisers. Sponsors, accountants, lawyers, appraisers, all have important roles in ensuring that our market functions properly.
34. Sponsors are at the centre of the process that brings any company to the public market. Their first responsibility is to understand properly the business and circumstances of their clients. Only then can they help their clients fulfill their responsibility in making proper disclosure.
35. The second part of the David Brown test is due process. Another equally important duty of a sponsor is to apply reasonable efforts to come to a view about its clients and their disclosure. This responsibility is variously articulated as a “duty to make due and careful enquiry”, a “duty of due care and skill”, an obligation to “satisfy himself that the issuer is suitable to be listed”, a duty to make “reasonable inquiry”, or the “due diligence defence”. While the details may differ among jurisdictions, the overall meaning is the same.
36. Unfortunately, some firms in the Hong Kong market misunderstand their responsibility and see themselves as mere “coordinators”, mechanically putting together disclosure documents (mainly the prospectus) from parts the company and the other professionals, e.g., the reporting accountants, provide. The focus is on producing the documents, rather than carrying out enough due diligence with the other professionals to understand the business of the company and to ensure that the documents contain the proper disclosure.
37. To some extent this is the result of unhealthy price competition, where firms “lowball” each other and cannot devote adequate resources to the transaction. There is also naturally a lot of pressure in “getting a deal done” once it begins. A client might not be willing to give the sponsor enough time for a proper job.

38. The third test is structure: to what extent are there internal controls and checks and balances within management boards, risk management techniques, and compliance functions within the corporation that minimize the emergence of fraud or misconduct? Indeed, many companies desire to list precisely because they wish to improve their internal structures, including incentive structures.
39. This is perhaps the difference between wedding consultants and traditional marriage middlemen. The former focuses only on how good the lucky couple looks on wedding day, whilst the latter focuses on a long and happy marriage for all.
40. As some of you know, the HKEx and SFC issued a joint consultation paper on sponsor regulation in May last year. We received a record number of responses and have received good comments from both the buy and the sell side. I am glad to report that we will be publishing our conclusions soon. In line with the wishes of the market, there will be a single regulatory regime for sponsors, and both the HKEx and Commission agree that we will enforce that regime. Accordingly, we will be working with our sponsor community on two important aspects: the proper code of conduct against which they can be assessed, and the due diligence that they are expected to undertake.
41. I totally agree with the comments made by the industry that sponsors cannot assume issuer liability. However, they have to be liable for their own standards of conduct and their role in due diligence. Once such criteria have been agreed together with the industry, and with the appropriate enforcement signals, I am confident that we will see significant improvements.
42. No talk about disclosure regulation can be complete without some discussion on the role of accountants. A company's financial statements are perhaps the single most important piece of corporate disclosure. If you could not trust the numbers, what could you go by?
43. As the professionals responsible for conducting an independent audit of the financial statements, the accountants have a crucial role. While the job of an auditor is not to ferret out frauds, proper audits do increase the difficulty in "cooking the books". Indeed, the principle is for auditors to "audit the business, not just the numbers".

44. We should recognize that new types of risks have emerged as our market evolves. Most new companies for listing are Mainland businesses with the bulk of their assets, operations, personnel, and records in the Mainland. The legal infrastructure and business environment there is different from that which Hong Kong auditors might take for granted. Furthermore, the Hong Kong auditors might not have known the client until shortly before the preparation for listing. Many other factors contribute to difficulties on the ground.
45. This is a challenge the accounting profession and the regulators must face together and address for the benefit of the market. I am glad to report that we are making progress on a number of fronts. At the international level, the promulgation of uniform international accounting and auditing standards, the creation of the Public Interest Oversight Board (PIOB) and work by IOSCO have resulted in a drive by the accountants and auditors to improve the quality of their work.
46. As some of you are aware, the role of the auditor and the requirement for audited accounts developed in the second half of the 19th century in England primarily in response to failures of some Joint Stock Companies. In an important case, the judge described the role of the auditor as being a watchdog but not a bloodhound⁶. Over the last 100 years a debate has ranged on what a reasonably cautious and careful watchdog is obliged to do.
47. The answer set out in the International Standard of Auditing⁷ published only last month is relevant for **all** watchdogs, be they auditors, regulators, audit committee members, analysts, and even staff. They need to maintain an attitude of professional skepticism throughout their work, recognizing the possibility that fraud could exist, notwithstanding past experience as to the honesty and integrity of management and those charged with governance. It is the duty of all of us to be aware that fraud may exist and plan and conduct our work with this in mind.
48. Within Hong Kong, the Government is finalizing with the Hong Kong Society of Accountants the establishment of a Financial Review and Reporting Panel and an Independent Investigation Board that would

⁶ Lord Justice Lopes' remarks in the case of Kingston Cotton Mill Co in 1896

⁷ The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements, International Standard on Auditing 240 (Revised) – approved February 2004

enhance the credibility of the profession in ensuring the quality of accounting, auditing and disclosure information.

Transparency and Quality of the Regulator

49. I have talked at length about how different parts of the disclosure regulation regime have to fit together to make it work. Disclosure works on the basis of sunshine – the more disclosed, the more the market can make informed judgments and put bad behaviour to the market test. Let me now move on to the role of the regulator.
50. For the regime of process, structure and ethics to work, regulators must also be transparent in the way we work. the market expect this to be the case in the listing process. Indeed, this is the best discipline on all regulators to ensure that we discharge our function fairly, firmly and consistently. Regulatory requirements should be set out for all to see. Practices and rationale for decisions should be communicated to the market, to avoid market confusion and accusations of bias. Issues that emerge should also be flagged to help practitioners understand the concerns and to bring out any general disagreement for discussion and consultation.
51. Transparency in relation to each individual case is also important. This starts with the regulator setting out fully reasoned comments. We have to justify, with references to facts, any concerns and the need for additional disclosure. Reasoning provides the necessary explanation and context for the company and its sponsor to “see where the regulator is coming from” and make the appropriate responses – as well as to make counterarguments if they disagree.
52. This is exactly what the SFC’s Dual Filing Team, which looks at corporate disclosure, has done. Our comments on individual cases are always set out in reasoned letters. We also make periodic announcements to update the market on our work, common issues, and sometimes serious problem cases. We also use this approach in our work on Takeovers Code.
53. In the longer term, we are exploring the potential for a central database of information for market users, containing disclosure by companies, funds, and other securities issuers, as well as information from regulators. This is to ensure that the investor in Hong Kong will

have ready and efficient access to both IPO and on-going disclosure on all types of publicly traded instruments in Hong Kong.

54. On the intermediaries front, disclosure regulation poses another challenge to the SFC. Our regulation of intermediaries involves both prudential and conduct supervision. Because of increasing focus on the role of sponsors under Dual Filing, and as an integral part of our efforts in disclosure regulation, there will be some consequential adjustment in allocation of our resources.
55. In conduct regulation, staff from more than one division in the SFC will bring their skills together, for example, to assess the level of due diligence. I am glad to report that these joint efforts are producing results. My colleagues in Dual Filing, intermediaries, and enforcement are already working on several sponsor-related cases where disclosure went wrong.

Conclusion

56. I have spent quite a lot of time over a complex subject that has recently engendered more heat than enlightenment. In public debate sometimes the real point is lost. Our focus should be on the maintenance of a fair playing field for investors as well as market participants. And to achieve this, we must recognize the complexity of the real world. The claim some people make that “if it is disclosed, it is alright” oversimplifies things.
57. All this suggests that responsibility for high quality markets depends on vigilance at all levels, from investors to issuers to intermediaries, the regulators as well as the media. My favourite cliché is that none of us is smarter than all of us. We all have a role in making sure that our markets are of high quality, so that there is continuing, if not growing confidence in our markets.
58. But in order to achieve this, we have rights as well as responsibilities. Disclosure should be meaningful to investors and should carry statutory liabilities with credible sanctions. Our approach recognizes the vital roles of market professionals. Equally importantly, we see a need to reduce the compliance burden on the majority of corporates and intermediaries who behave well and instead focus on enforcement actions against those who abuse the market.

59. As we move to improve our disclosure regulatory regime, and as we encounter new challenges arising from the fast-developing Mainland environment and ever-changing world, we need to be talking to each other openly, sharing concerns and finding solutions. Conferences like this serve as an important forum of communications. I wish you all the best.

Securities and Futures Commission
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