OICV-IOSCO 28th ANNUAL CONFERENCE
of the International Organization of Securities Commissions
14~17 October 2003, Seoul Korea

Plenary 3

New Stringent Avenues of Corporate Governance

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17 October 2003

IOSCO Annual Conference
Seoul, Korea

Panel 3: New Stringent Avenues of Corporate Governance

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Friday, 17 October 2003

Corporate Governance Lessons post-Enron

- Corporate Governance cannot be considered independent of social, legal and institutional environment – there is no one-size fits all solution
- Two key elements: performance and conformance
- Global competition is driving global standards of corporate governance, but how to change corporate behaviour depends on clear understanding of overall context of institutional development and growth.

Post-Enron, 3 key issues

- What additional checks and balances are needed for management performance and conformance?
- What are the appropriate sanctions?
- How to implement market reforms more effectively?

Additional checks and balances

- Core Principal/Agent issue: balance of power between the executive and stakeholders
- Better disclosure and transparency – "seeing through eyes of management" restores balance of power towards stakeholders and improves accountability of executive

Disclosure is key, but several caveats

- Information overload – more does not mean better
- Information production imposes costs to produce and analyze
- Small and unsophisticated retail investors do not necessarily comprehend most of complex information disclosed
- No disclosure standard can prevent deliberate fraud

Quality of information

Ensure quality by looking at:

- Relevance, materiality, comparability, consistency and timeliness
- Accounting, auditing and disclosure standards used
- Integrity of the issuer, preparer, auditor and corporate advisers involved (governance process of disclosure)
- Key assumptions used in producing information

More stringent rules on integrity of information and disclosure

Sarbanes- Oxley mandates :-

- More clear and personal responsibilities so conflicts are identified and addressed
- CEO/CFO to certify financial statements, and statements on internal controls
- Sanctions for failure results in disgorging compensation following restatement of financial statements
- Similar rules imposed in other jurisdictions

Appropriate Sanctions

- Post-Enron, more and heavier sanctions against breaches;
- Increasing trend for civil action and civil fines
- Need for graduated and targeted approach to regulatory discipline i.e. sanctions proportionate to seriousness of the offence
- Hong Kong SFO introduced Market Misconduct Tribunal, with judge + 2 lay professionals to hear cases

Punishing alone does not work

- Old Chinese saying: In implementing the law –
- Best is to persuade
- Second is to deter
- Third is to punish

Reform Headwinds

- Increasing signs of reform fatigue: common complaints –
- Too much rule changes, too quick, little time to absorb implications
- Risks of law of unintended consequences
- Excessive regulations deter market innovation and growth and may not benefit investors
- Costs of regulatory compliance mounting – bearable for large firms, tough for small firms

Managing the Reform Process

- We cannot change everything at once – need to prioritize
- Major dilemma - Balancing the conflicting interests
- Vested interest; conflicts of interest; public interest
- Need for wide market consultations and consensus
- Ownership of change is best, but not easy to achieve

Role of regulator

- Market works best when transaction costs, including regulatory costs, are low
- Generally, market works well, but public interest must be protected by:
  - Ensuring orderly fair and efficient markets
  - Enforcing rules with even hand
  - Regulatory action has wide support of the public
- Need independent checks and balances –
  - Hong Kong has independent Process Review Panel to ensure that due process in our regulatory and enforcement work is carried out as fairly and transparently as possible

Conclusion

- Much needs to be done, but reforms cannot be done by regulators alone
- Corporate Governance change requires cultural and institutional change – much forced by globalisation
- We have to be clear what our reform goals are – to have world class standards of fair and transparent markets
- We need to have process to manage the reform process – to ensure that we have widespread support of all stakeholders in our reform goals

THANK YOU