CHAPTER 5
OTHER REMARKS

5.1 In the course of our review, we have come across some issues which are considered to be of importance to the financial markets but are clearly outside our immediate terms of reference. In this chapter we respond to the invitation by the FS to flag these issues for the Government's consideration.

CASE FOR A SINGLE CORPORATE REGULATOR

5.2 Quite a few submissions and comments we received pointed out the absence of a single corporate regulator in Hong Kong, and that the shared regulation of companies by multiple agencies had led to confusion and inefficient regulation. There was a suggestion that the SFC should take on the role of the statutory regulator of **all** companies, with the Companies Registry subsumed under it, to achieve synergies and economies of scale as well as consistency in regulatory actions. This is very similar to the arrangements in Australia, for example.

5.3 Under the present regulatory regime, the HKEx is the front line regulator of companies listed on its stock exchange and the Companies Registry deals with the incorporation and registration of companies. Oversight of company conduct involves the HKEx which administers the Listing Rules, the SFC which administers the Codes on Takeovers and Mergers and Share Repurchases, the ICAC which deals with corruption cases and the CCB on fraud and theft. In addition, the FS can appoint inspectors under section 142 or 143 of the Companies Ordinance to investigate company activities.

5.4 It has been put to us that the need to coordinate the regulatory efforts of the various regulators has led to delays in regulatory response, because no one regulator has the total picture of what the perpetrator is up to. There is a widely held view that enforcement of the Companies Ordinance has not been adequate, probably due to the lack of investigative capabilities and resources on the part of the Companies Registry.

5.5 As far as we are aware, only Australia and Pakistan have adopted the "single corporate regulator" approach to regulate the operations of companies. Most other jurisdictions have, like Hong Kong, gone for the shared regulation model. We are confident that the regulation of listed companies will be enhanced with the listing function transferred from the HKEx to the SFC, which would among other things reduce regulatory arbitrage by companies. On the other hand, it is clear to us that the Companies Registry has been hampered by resource constraints on its investigative and prosecution work in enforcing the provisions of the Companies Ordinance and the fact that about 80% of listed companies are incorporated outside Hong Kong. We therefore consider that the Government should seriously look into the viability of subsuming the Companies Registry under the SFC and turn the latter into a dedicated statutory regulator of all companies.

CLASS ACTIONS BY INVESTORS TO SEEK REDRESS

5.6 Some submissions we received commented on the inadequacy of current shareholder remedies. One suggestion is to introduce the private class action system practised in the US whereby a securities class action may be brought pursuant to the Federal Rules of Civil Procedure on behalf of a group of persons who purchased the securities of a particular company during a specified period of time, if it is alleged that the company and/or certain of its officers and directors violated one or more of the federal or state securities laws. Together with the contingent legal fees ("no-win-no-fee") mechanism, this system appears to have provided investors with an affordable way to seek redress. It should be noted however the system has been accused of encouraging frivolous private securities litigation in the US, and these rights of action were to some extent curbed in the mid 1990s. Nevertheless private rights of action are widely regarded as one of the main reasons why the US market is seen to be effectively regulated.

5.7 Presently under the common law, a person in Hong Kong who has suffered loss as a result of market misconduct may seek redress through a civil action against the person responsible for that misconduct. The soon to be effective SFO will provide investors with the rights of civil action to institute civil proceedings to claim compensation from persons for any pecuniary loss that the former has sustained as a result of the reliance on the fraudulent, reckless or negligent misrepresentation by the latter. It has however been pointed out that minority shareholders in Hong Kong are rarely able to justify the costs involved in taking private legal action against alleged market misconduct by directors and/or controlling shareholders, which can be prohibitive when compared to the amount of compensation claimed.

5.8 The Standing Committee on Company Law Reform has proposed in the Consultation Paper on Proposals Made in Phase I of the Corporate Governance Review other possible remedies, including giving shareholders and the SFC a statutory right of derivative action on behalf of the company, in cases of fraud, negligence or breach of duty. In this connection, the Government will introduce into the Legislative Council a Companies (Amendment) Bill in 2003 to create, among others, a provision to provide shareholders a statutory right of derivative action. The

Government also plans to release jointly with the SFC in 2003 a consultation paper on the concept of empowering the SFC to take derivative actions for minority shareholders.

5.9 While any initiative to give investors more legal rights to seek remedies is to be welcome, we are not entirely convinced that statutory derivative actions will be of much practical help to small investors as these actions will need to be paid for by the plaintiff until the case is won and damages are awarded. Even if a case is won, the damages will go to the company which is still controlled by the people who caused losses in the first place and it is doubtful whether the plaintiff will receive his or her rightful share of compensation. The same consideration applies also to derivative actions taken by the SFC, about which there could be debates on whether public funds should be expended to seek compensation, without certainty of success, for private investors. Although this issue is definitely outside our remit, we would suggest that the Government should also look into the feasibility of introducing either contingency fees based class actions, or the Australian system of pre-trial hearing in which a judge decides whether the claimant has any reasonable prospect of success, and if he or she does, may order **the company** to fund the claim. The court's discretion to award costs should deter frivolous suits in either a class action system or a preliminary funding case.

PROSPECTUSES AND COMPANY ANNOUNCEMENTS

5.10 There were criticisms about prospectuses and company announcements being too complex, legalistic and difficult to understand. It was suggested that they should contain only essential information and should be written in a way that can be understood by the average investors. We agree that efforts should be made to simplify the format of prospectuses and company announcements with emphasis on clarity, conciseness and plain language. Various other jurisdictions, including the UK and Australia, have done a great deal of work on this, as has the IOSCO. If our proposal is adopted, we suggest this should be a priority for the SFC and its HKLA.

REGULATION OF VALUERS

5.11 Although the work of valuers has significant impact on IPOs and connected transactions of listed companies through the valuation of the issuers' assets and brand names of companies, valuers are, unlike accountants and lawyers who are regulated and bound by the standards and rules of their respective self-regulatory organisations, not subject to any formal regulation. In light of recent corporate scandals involving grossly overstated assets, there are voices in the market that call for proper regulation of valuers. Some valuers have in fact expressed support for regulation on grounds that they would then be able to better resist pressure from their clients to make valuations which are in favour of the companies but not in the best interests of investors.

5.12 We note that the HKEx has proposed to consult the market on amendments to the Listing Rules to tighten regulation of IPO intermediaries, including valuers. Separately, the SFC has put forward proposals to the Standing Committee on Company Law Reform on amendments to the Companies Ordinance to extend prospectus-related liability to IPO sponsors, and possibly other IPO intermediaries, for ensuring quality disclosure to investors. We welcome and support such moves which could only be good for the healthy development of the Hong Kong market.

STAFF SECONDMENTS

5.13 We have received a suggestion that secondments of executives from the industry to the SFC should be encouraged in order to improve the SFC staff's understanding of the industry which they regulate. The secondees themselves would benefit by gaining first-hand experience of the operation of the regulator, which should help their companies' compliance work when they return to their own jobs at the end of the secondment. We note that some overseas regulators, such as the FSA in the UK, have a policy of encouraging secondments from the relevant industry sectors and believe that the SFC and the Hong Kong market should be able to benefit from such an arrangement.

5.14 We understand that the SFC has in fact been hiring directly from the market professionals with considerable experience in recent years. So perhaps the need for a large number of secondees is not as great as it might have been in the past. Nevertheless, it is also our understanding that the SFC recognises the potential benefit of such an initiative particularly where the secondee has specialist knowledge. We do realise that there are certain conflict of interests issues which must be managed effectively in any discussion of this subject.