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HK LESSONS FOR ENHANCEMENT OF SGX ENFORCEMENT POWERS

Much can be learned in a study on the impact of public reprimands in HK – examining their impact on stock returns and board turnover, and also on other directorships held by directors who have been reprimanded. BY MAK YUEN TEEN

ON SEPT 17, 2014, the Singapore Exchange (SGX) issued a consultation paper with details of proposed measures and rule amendments to reinforce the SGX listings and enforcement framework. This was a follow-up to the joint consultation paper issued by the Monetary Authority of Singapore (MAS) and SGX in February 2014 on the review of the securities market structure and practices, including the listings and enforcement framework.

Currently, the range of enforcement powers available to SGX against issuers and their directors and management include, among other actions, the issuing of letters of advice, private warning letters, and public reprimands. SGX believes that "the current range of enforcement powers is inadequate in cases where the issuance of warning letters or reprimands is not severe enough, while the removal of an issuer from the Official List is too harsh". SGX is therefore seeking the power to impose "a greater range of sanctions, which are commensurate with the severity of the breach".

Even though SGX already has the power to issue public reprimands, it has used it only sparingly, based on regulatory actions published on the SGX website and newspaper reports. There were only eight cases of public reprimand of issuers or directors between 2001 and 2009, mostly for poor disclosures. The only directors who were reprimanded during that period were the late tycoon Khoo Teck Puat's two daughters, for failing to disclose their father's stake in several companies in which they were directors. That was in July 2005, after the court had already fined them for those offences and they had voluntarily undertaken to not take up any directorship in listed companies for five years. In that case, the public reprimand was arguably symbolic.

Public reprimands of issuers and/or their directors peaked in 2010 when SGX reprimanded three issuers and blacklisted 10 executive directors in six other issuers. 2010 also was the year that SGX started targeting directors in their reprimands. In all the public reprimands associated with 14 issuers from 2010 to 2013, SGX singled out directors (and, in some cases, other employees). In seven cases, only the directors and not the issuers were reprimanded, and these were all executive directors. In six other cases, the issuers and some or all of the directors were reprimanded, while in one case, the issuer was reprimanded while the directors were named (although not specifically reprimanded).

The latest public reprimand – apparently the only public reprimand for 2014 – was issued on Dec 30, 2014 against New Lakeside Holdings, one of its former executive directors and the former group CFO. This public reprimand came four years after a review commissioned by the audit committee had revealed breaches of listing rules and corporate governance failures dating as far back as 2006. The company has since changed its name, and restructured its business, board and management. This and other cases also raise issues about the timeliness of public reprimands by SGX.

In contrast, Hong Kong has had a long history of using public reprimands against issuers and directors. There, the Listing Committee ("the Committee") is responsible for the Stock Exchange of Hong Kong's (SEHK) enforcement actions. The Committee has at least 28 members nominated by the Listing Nominating Committee made up of three non-executive directors of the Hong Kong Exchanges and Clearing Ltd (HKEx) and the chairman and two executive directors of the Securities and Futures Commission (SFC). The Committee's remit is wide, and includes responsibilities for enforcement and certain listing matters.

The Committee employs a dual approach in its enforcement. First, it punishes conduct of issuers and directors through a range of disciplinary actions, including but not limited to a private reprimand, a public criticism and a public censure. A censure is more serious than a criticism.

Second, SEHK can instruct the issuer to take remedial actions to improve corporate governance, such as appointing an adviser to conduct an internal control review and implement the recommendations; appointing a compliance adviser to advise the issuer on listing rules compliance; and director training on relevant laws and regulations.

> In the longer term, an arguably better and more sustainable option to improve investor protection and enforcement is to place the enforcement role under a separate regulatory body and establish a separate securities regulator.

In deciding whether to take disciplinary action, the Committee first considers whether the breach was reckless or deliberate and the degree of culpability. It then evaluates the seriousness of the breach, in terms of the impact on the orderliness and reputation of the market, and risk of prejudice to investors.

The Committee can reprimand the issuer alone, the directors alone, or both the issuer and directors together. In deciding whether to reprimand directors, SEHK considers whether they are liable for substantive breaches of listing rules by the issuer or if they have failed to create and maintain adequate internal controls to achieve compliance.

Together with my colleague Ho Yew Kee and former student Gladys Lee, we recently completed a study on the impact of public reprimands in HK. We examined their impact on stock returns and board turnover, and also on other directorships held by directors who have been reprimanded. We also examined whether the two different types of reprimand – censure and criticism – had different impact, and whether the impact differs based on parties censured (that is, issuer, issuer and directors, and directors only) and nature of the breach. Our initial sample included all enforcement notices published on the Exchange's website from 1999 to 2012. During this period, SEHK reprimanded 174 issuers and between 1999 and 2010, it reprimanded 434 directors.

Rather surprisingly, we found that only criticised issuers experienced significant negative market reaction on announcement of the reprimand, while we did not observe significant market reaction for censured firms in spite of censures being more severe. We also found some evidence that the market reacted more negatively when issuers were reprimanded for failure to obtain independent shareholders' prior approval for related-party transactions. Overall, however, the evidence on impact of reprimands on stockmarket returns is, at best, mixed – perhaps because the market had already impounded them into stock prices.

Reprimanded issuers had a significantly higher board turnover in the years surrounding the reprimand, relative to a comparable sample of issuers that were not reprimanded. This increase was especially pronounced when the directors were individually reprimanded, and where the reprimand was in the form of a censure. In other words, reprimands did appear to cost some directors their directorship in the issuer associated with the reprimand. However, censured directors did not evidently suffer a greater loss in other outside directorships than criticised directors, even though censures are supposed to be the more severe form of reprimand. Rather, there is evidence that reprimanded directors who left the issuer suffered a greater loss in other outside directorships than reprimanded directors who remained. What this means is that a reprimand by itself does not appear to affect the ability of a director to retain or obtain other directorships.

So, what can we learn from the Hong Kong experience? First, there should be a clear and transparent enforcement policy, which explains the enforcement process and the factors taken into consideration in administering enforcement actions. SGX can also consider calibrating reprimands according to degree of seriousness of the breach and the culpability, and it should carefully consider under what circumstances it would reprimand issuers, issuers together with directors, or just specific directors. It is important that SGX is seen to be fair, transparent and consistent in its enforcement.

Second, in establishing the Listings Disciplinary Committee (LDC) and the other committees, there should be a proper nominating process. The last thing we want is the lack of proper governance in establishing structures that are designed to enhance governance. The proposals are silent on the number of members on the LDC although it specifies a minimum quorum of five members for each hearing. There should be a sufficiently large number of members on the LDC to be able to select the appropriate members for each hearing. This will allow proper implementation of conflict-of-interest rules that ensure that members who are conflicted are not asked to make decisions on disciplinary matters. Given the close-knit business community here and the fact that experienced industry professionals will be serving on the LDC, the risk of conflicts should not be underestimated. It is also important to manage the workload of committee members by sharing it among different members, given that they are essentially going to be volunteers who are paid only an honorarium to ensure that their independence from SGX is not compromised.

Third, based on the HK experience, reprimands alone may have limited real impact on directors who are responsible for breaches, given that they appear to at most lose their directorship in the issuer associated with the reprimand. In this regard, the proposals to allow SGX to object to the appointment of directors or executive officers in specified circumstances for a period not exceeding three years, and for the LDC to require the resignation of a director or executive officer from an issuer and to issue an order prohibiting his appointment or reappointment in any issuer for a period not exceeding three years, can increase the deterrent effect of public reprimands and other sanctions.

Increasing the range of sanctions and giving SGX more teeth in enforcement can potentially improve enforcement. However, I believe that the creation of the three committees to improve the listings and enforcement framework is a second-best option, which may not be sustainable in the longer term. When we have to augment an existing structure with appendages to address perceived weaknesses in that structure, we have to ask whether the basic structure itself should be changed. Can and should important responsibilities such as enforcement be essentially outsourced to committees made up of part-timers? Given the committees' reliance on SGX (such as for investigations) and on the secretariat supporting them, how "independent" and involved will these committees really be?

Although the use of a separate Listing Committee in HK for enforcement and listing matters appears to have worked reasonably well, only time will tell whether it will work here – and the transparency and governance of the committees themselves will be important. In the longer term, an arguably better and more sustainable option to improve investor protection and enforcement is to place the enforcement role under a separate regulatory body and establish a separate securities regulator.

The writer is associate professor of accounting at the NUS Business School, where he teaches corporate governance and ethics. The research on Hong Kong discussed in this piece is based on the article 'The Impact of Public Reprimands' by Ho Yew Yee, Gladys Lee and the writer

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