

# The Stock Exchange's Strategy for Enforcing the Listing Rules

## Introduction

The Stock Exchange works to both enforce the Listing Rules and promote compliance. The Exchange seeks to detect rule breaches quickly, to take action to minimise the impact of the rule breach, typically this will result in disclosure by the listed company, and where possible to alert investors and other market participants of the wrongdoing. Potential rule breaches are uncovered through a range of activities, including the Listing Division's surveillance activities and research and data analysis, and from many sources including tip-offs and complaints received from the public and media commentary.

Each year the Exchange makes enquiries and investigates several hundred potential rule breaches. Depending on the type of conduct involved the Exchange is able to deploy a variety of graduated responses for non-compliance. Disciplinary sanctions are one of the regulatory responses available to the Exchange but they are not the only response available and it may be possible to address instances of non-compliance without resorting to disciplinary action. Other non-disciplinary measures available where the Exchange considers it necessary to take protective or remedial action include suspension or, in exceptional circumstances, the cancellation of listing.

The Exchange may suspend trading in a listed company's securities where there is inadequate disclosure or a listed company fails to comply with the continuing obligations of listing in a manner severe enough to justify suspension. The Exchange's policy on Share Trading Suspension was described in the last edition of "The Exchange".

## Criteria for Determining Whether to Take Disciplinary Action

In determining whether to take disciplinary action the Exchange will consider the full circumstances of each case. The Exchange may take into account a number of factors in determining whether to initiate disciplinary

action. The two most significant factors are:

- the seriousness of the breach of the Listing Rules. In considering this question the following may be relevant:
  - the nature of the breach, including the impact on the orderliness and reputation of the market and any prejudice or risk of prejudice to investors (for example, cases involving a failure to obtain prior shareholder approval for connected transactions or a failure to make timely and accurate initial or continuing disclosure of material price sensitive information);
  - the duration and frequency of the breach;
  - whether the breach revealed serious or systemic weaknesses in the listed company's procedures; and
  - the extent to which the breach departs from current market practice; and
- evidence that the breach was deliberate or reckless. There are a range of issues the Exchange may consider in this context including, but not limited to: whether the directors foresaw the consequences of their company's behaviour; whether there was a failure to comply with the listed company's procedures or guidance issued by the Exchange; whether the directors put in place appropriate steps to ensure the company complied with obligations under the Listing Rules and whether the directors turned their minds to the question of what steps were necessary to achieve this objective; whether the directors took decisions beyond their field of competence; and whether consideration was given to the consequences of the conduct that constitutes the breach of the Listing Rules.

The criteria noted above are not exhaustive.

The Exchange's approach to determining whether or not to commence disciplinary action means that those who act with due care, in good faith and with a proper understanding of their responsibilities should not be exposed to disciplinary sanctions nor to potentially costly and disruptive disciplinary investigations.

### **Review of Disciplinary Processes**

Over the last 18 months the Exchange has modified and refocused its approach to enforcing the Listing Rules. This exercise commenced with a review of the disciplinary processes of referral, investigation and decision making. At the start of this process the Listing Enforcement Department was established to provide a focus and momentum to the review. The Listing Enforcement Department has implemented a number of initiatives to improve the timeliness and effectiveness of disciplinary action taken by the Exchange:

- redeploying staff and resources to increase the number of staff dedicated on a full-time basis to investigating rule breaches and conducting disciplinary proceedings;
- overhauling the investigation practices and procedures to reduce the number of inquiries made and gather information more efficiently. In selected cases this involves requiring directors to attend interviews and answer questions;
- developing a system of case prioritisation to maximise resources devoted to investigation and disciplinary action in respect of rule breaches which are most damaging to investor perceptions of the reputation and integrity of the market, namely failure to obtain prior shareholder approval for connected party transactions and to make timely, accurate or complete initial or continuing disclosure of information relevant to investment decisions;
- an approach was agreed with the Listing Committee to streamline investigation and disciplinary action in relation to certain types of reports, namely first time breaches of the requirement to issue financial reports within a specified period. In such cases the Division would generally recommend a public

statement of criticism against the company but not the directors and so would only be required to conduct a short investigation to establish the breach and issue a brief report. In such cases, three or more hearings could be scheduled for a single meeting of the Committee;

- the Exchange's approach to settling disciplinary matters was agreed with the Listing Committee in 2003, making the process of settling matters more straightforward and more predictable and has resulted in an increase in the number of matters subject to settlement (none in 2002, three in 2003, two in the nine months to the end of September this year); and
- a revised approach to publicising the outcome of disciplinary cases was agreed with the Listing Committee. The practice of publicising disciplinary sanction by way of paid advertisements in newspapers has been discontinued and replaced by a modified form of news release which is distributed to news media and posted on the HKEx website. The format of the news release includes a summary of the decision of the Listing Committee, including a brief recital of the facts of the case, the rules in breach and the public sanction imposed together with a commentary, usually by the Head of Listing, on the Exchange's views on the relevant compliance matters.

### **Record of Improvement**

As a consequence of these various changes, there has been a steady improvement in the number of disciplinary decisions issued by the Listing Committee and in the character of those decisions:

- in 2002 the Listing (Disciplinary) Committee issued 14 disciplinary decisions including six public censures, one public statement involving criticism and seven private reprimands. Of these disciplinary decisions, 10 involved breaches of financial reporting deadlines; two involved breaches of the obligation to obtain independent shareholder approval for connected transactions and two involved disclosure breaches;

- in 2003 the Listing (Disciplinary) Committee issued 13 disciplinary decisions including three public censures, six public statements involving criticism, two private reprimands and two with no finding of breach. Of these disciplinary decisions, one involved breaches of financial reporting deadlines; two involved breaches of the obligation to obtain independent shareholder approval for connected transactions; six involved disclosure breaches; three involved breach of the Model Code for Director's Dealings and one involved breach of the share repurchase requirements; and
- in the period from 1 January to 17 September this year, the Listing Committee issued 21 disciplinary decisions including three public censures, 14 public statements involving criticism, three private reprimands and one with no finding of breach. Of these disciplinary decisions, 15 involved breaches of financial reporting deadlines; five involved disclosure breaches and one involved breach of the share repurchase requirements.

This shows that while the number of disciplinary decisions was more or less the same in 2002 and 2003, the decisions issued in 2003 were more serious both in terms of the nature of the breaches and the sanctions imposed. The decisions to date this year show a major improvement in respect of numbers and sanctions imposed although in terms of the pattern of breaches the cases were closer in character to 2002 rather than 2003. The explanation for this has two aspects. Firstly, the streamlined approach for late financial reporting cases has made it easier and quicker to obtain outcomes in those cases. Secondly, cases involving more serious breaches and sanctions are subject to significant delays as a result of requests for extensions of time in making submissions and procedural challenges.

This is demonstrated by a comparison of disciplinary cases for which proceedings had commenced but had not been heard as at mid-September this year (17, none

of which were streamlined cases) with those at mid-September 2003 (12, four of which were streamlined cases).

A consequence of the initiatives to improve the efficiency, effectiveness and timeliness of enforcement work is an increase in the burden on the Listing (Disciplinary) Committee, the members of which give their time voluntarily. The manner in which the Exchange is addressing the issue of first instance decision making in disciplinary cases is set out in the article on page 8 entitled "Update on Restructuring of Listing Committee".

### **Conclusion**

Enforcement is an important activity for the Exchange as the frontline regulator of listed companies but it is not an end in itself. Its principal purpose is to change future behaviour by demonstrating that breaches of the Listing Rules will be identified and the sanction imposed will have a cost or adverse impact on the companies and individuals concerned.

Market observers and the general public have raised concerns about the limited range of sanctions available to the Exchange. There is a perception in some quarters that the sanctions available to the Exchange do not act as a sufficient deterrent and are being treated by some as a minor cost of doing business in the manner preferred by those parties.

In response to these concerns the Government has recommended the creation of statutory obligations for compliance with the most important listing requirements. Breaches of these statutory listing requirements would attract a graduated range of proportionate civil and criminal sanctions.

The Exchange welcomes this recommendation, which is consistent with its views, and looks forward to the forthcoming consultation exercises which will flesh out the detail of these proposals.