UNDERSTANDING THE ENFORCEMENT STRATEGY FOR REGULATING THE LISTING MARKET OF HONG KONG

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This paper examines how Hong Kong regulators deploy their enforcement powers in order to regulate the listing market. As a former British colony, Hong Kong follows the enforcement style of the UK with regard to financial regulation where alternative mechanisms are used to substitute heavy reliance on formal sanctions to procure compliance. Nevertheless, it is argued that the enforcement strategy of Hong Kong regulators is also shaped by the need to overcome cross-border enforcement problems concerning Mainland Chinese companies which maintain a strong presence in the Hong Kong market. In response to difficulties in cross-border enforcement, Hong Kong regulators have resorted to a dynamic mix of different regulatory tools – formal sanctions and compliance-promoting measures, *ex post* enforcement actions and *ex ante* controls, direct deterrence and gatekeeper supervision – to try to achieve effective enforcement.

Key words: enforcement strategy, regulation, listing market, Hong Kong

A. INTRODUCTION

Hong Kong boasts itself as a major international financial market in Asia. The Hong Kong Stock Exchange currently ranks sixth among the exchanges around the world in terms of market capitalisation.[1] Though not the largest in size, it constantly performed well in attracting new listings during the last decade. In particular, Hong Kong led the world in total funds raised through initial public offerings (IPOs) for three consecutive years from 2009 to 2011.[2] The vibrancy of the listing market of Hong Kong, however, gave rise to concerns about its regulatory standards. As John Coffee has suggested, a market may attract foreign listings and offerings due to its relaxed regulation.[3] He further notes that there are studies

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[1] World Federation of Exchange, "2012WFE Market Highlights" (22 January 2013), 6 <www.world-exchanges.org/files/statistics/2012%20WFE%20Market%20Highlights.pdf> accessed 4 December 2013.

[2] Hong Kong Exchanges and Clearing Limited (HKEx), "Hong Kong Leads World in IPO Fundraising for Three Consecutive Years and Attracts More International Listings" (*Exchange*, January 2012), 2 <www.hkex.com.hk/eng/newsconsul/newsltr/2012/Documents/2012-01-02-E.pdf> accessed 4 December 2013.

[3] John C. Coffee, Jr., "Law and the Market: The Impact of Enforcement" (2007) 156 *University of Pennsylvania Law Review* 229, 308.

which have found that issuers have been turning away from the US after the enactment of the Sarbanes-Oxley Act to what Coffee regarded as "less intensively regulated securities markets" such as in London and Hong Kong.[4] The suggestion that issuers now migrate to Hong Kong for the purpose of avoiding the US' high regulatory burden has contributed to the impression that Hong Kong attracts foreign listings mainly due to its low regulatory standards. Such an impression is indeed noted by Hong Kong regulators who consider it damaging to Hong Kong's reputation as an international financial market and have consequently forcefully refuted it.[5]

On the other hand, recent literature which endeavours to demonstrate the positive correlation between the quality of law enforcement and the size of a financial market depicts a completely different picture of the regulatory environment of the Hong Kong market. For instance, Hong Kong achieves a remarkable score in the public enforcement index composed by Rafael La Porta and others,[6] which shows that the performance of Hong Kong in enforcing securities law is just behind that of Australia and the US, and on a par with Singapore.[7]

[4] Ibid 234. Among the works cited by Coffee for the proposition that foreign issuers are leaving the US and migrating to other overseas markets are two reports produced respectively by the Committee on Capital Markets Regulation, *Interim Report of the Committee on Capital Markets Regulation* (30 November 2006) <www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf > accessed 4 December 2013, and Michael R. Bloomberg and Charles E. Schumer, *Sustaining New York's and the US' Global Financial Services Leadership* (2007) <http://apps.americanbar.org/buslaw/committees/CL116000pub/materials/library/NY_Schumer-Bloomberg_REPORT_FINAL.pdf> accessed 4 December 2013. It should be noted that the two reports do not attribute the migration of foreign issuers solely to the problem of overregulation and draconian enforcement in the US markets but point out that overseas markets have also enhanced their competitiveness through financial and regulatory improvements. For instance, the report by the Committee on Capital Markets Regulation (in p 40) observes that "the Hong Kong securities regulatory environment also has improved substantially in recent years, although some still consider the regime too lax".

[5] See Martin Wheatley, "SEC Regulation Outside the United States Conference: Opening Remarks at Regulators Forum" (15 November 2005), 2 <www.sfc.hk/web/doc/EN/speeches/speeches/05/mw051115_eng.pdf> accessed 4 December 2013; Ronald Arculli, "The Hong Kong Exchange: the World at China's Door," Luncheon Keynote Speech at Credit Suisse Asian Investment Conference (30 March 2007) <www.hkex.com.hk/eng/newsconsul/speech/2007/sp070330.htm> accessed 4 December 2013.

[6] Rafael La Porta, Florencio Lopez-De-Silanes, and Andrei Shelifer, "What Works in Securities Laws?" (2006) 61 *The Journal of Finance* 1, 15, Table II.

[7] Both Australia and the US top the index by scoring the mark of 0.9 out of the full mark of 1 under which the mark for Hong Kong is 0.87. See ibid.

Moreover, Jackson and Roe who employ the "resource-based approach" to measure law enforcement intensity in financial markets find that Hong Kong is among the group of jurisdictions which have devoted the highest staffing and budgets to securities regulators.[8] The authors comment that "the Hong Kong observation seems accurate and consistent with reports from international securities lawyers we consulted who report Hong Kong as having one of the world's most intense securities regulators".[9] The impressive results for Hong Kong in securities law enforcement have led Yeung and Huang to believe that Hong Kong has adopted the US style of public enforcement which resorts extensively to criminal prosecutions and *ex post* sanctions to combat law-breaking behaviour.[10]

This paper argues that neither a light-touch regulatory regime nor an enforcement-led style of public oversight noted in the preceding discussion is an accurate depiction of the regulation of Hong Kong's listing market. Additionally, it contends that the erroneous images reveal a lack of understanding of how Hong Kong regulators actually deploy their enforcement powers. Hence, this paper aims to foster a better appreciation of Hong Kong's regulatory environment by examining the regulators' strategy of enforcing the legal rules and ensuring compliance. The focus on the enforcement strategy acknowledges that the process of law enforcement does not work like a mechanical or reflexive reaction to rule violations, and regulatory agencies are endowed with discretion over when and how to exercise their enforcement powers in tackling non-compliance.[11] The manner of their enforcement is often the consequence of interactions between the institutional setting of a jurisdiction and specific

[8] Howell E. Jackson and Mark J. Roe, "Public and private enforcement of securities laws: Resource-based evidence" (2009) 93 *Journal of Financial Economics* 207, 214-15.
[9] Ibid 223.
[10] Horace Yeung and Flora Xiao Huang, "Law and Finance: What Matters? Hong Kong as a Test Case" (2012) 3 *Asian Journal of Law and Economics* 1, 13-17.
[11] This aspect has long been pointed out by socio-legal scholars. See, eg, Keith Hawkins, *Law as Last Resort: Prosecution Decision-Making in a Regulatory Agency* (OUP 2002). For a more general discussion of the use of discretion by legal actors, see Keith Hawkins (ed), *The Uses of Discretion* (Clarendon Press 1992).

policy considerations, which can seldom be fully illustrated by studies adopting a transjurisdictional comparative approach.[12]

As will be shown later, prosecutions and *ex post* sanctions constitute only a small part of the enforcement strategy of Hong Kong regulators. Rather, compliance-based measures and *ex ante* controls are frequently used to complement formal sanctions for promoting compliance. To some degree, this enforcement strategy reflects the British legacy. As a former British colony, Hong Kong's system of stock market regulation was inherited from the UK which has traditionally emphasised self-regulation and informal controls.[13] Nevertheless, it is argued in this paper that the strategy is also a response to enforcement problems relating to Mainland Chinese companies which maintain a significant presence in the stock market of Hong Kong. Although listed in Hong Kong, these companies operate primarily in Mainland China[14] where the legal environment is very different from that of Hong Kong. Practical difficulties in cross-border enforcement set limits on direct deterrence and therefore require Hong Kong regulators to adjust their enforcement strategy accordingly.

[12] John Coffee has put particular emphasis on the number of formal sanctions, which, he maintains, indicate that the US has a high level of enforcement intensity unmatched elsewhere in the world; Coffee (n 3) 309-10. However, the low incidence of these actions in other jurisdictions does not necessarily imply lax regulation. The UK, for example, has used alternative enforcement mechanisms to substitute heavy reliance on formal enforcement actions. See, eg, John Armour, Bernard Black, Brian Cheffins, and Richard Nolan, "Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and the United States" (2009) 6 *Journal of Empirical Legal Studies* 687, 718-20; Kathryn Cearns and Ellis Ferran, "Non-enforcement-led Public Oversight of Financial and Corporate Governance Disclosures and of Auditors" (2008) 8 *Journal of Corporate Law Studies* 191. Jackson and Roe try to get around this problem of enforcement style or strategy by comparing only resources allocated to a regulatory authority. However, this method has clear limitations as the authors have admitted themselves, for it cannot determine whether a regulator deploys the resources efficiently or even whether the resources are used for enforcement or other purposes. See Jackson and Roe (n 8) 210-11.

[13] This aspect of the UK financial regulatory system is highlighted in, eg, John Armour, "Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment," in John Armour and Jennifer Payne (eds), *Rationality in Company Law* (Hart Publishing 2009) 71-119; Cearns and Ferran (n 12); Iain MacNeil, "The evolution of regulatory enforcement action in the UK capital markets: a case of 'less is more'?" (2007) 2 *Capital Market Journal* 345.

[14] The term "Mainland China" or "the Mainland" is used in this paper to refer to the People's Republic of China excluding the two special administrative regions of Hong Kong and Macau.

The structure of this paper is as follows: section B provides an overview of the regulatory system regarding the stock market in Hong Kong and highlights the enforcement problems arising from the listing of Mainland Chinese companies. Section C studies the attempts made by Hong Kong Exchanges and Clearing Limited to complement its restricted enforcement powers through a number of measures which aim to procure voluntary compliance. Section D examines the actual operation of the "dual-filing" system which was introduced to increase the element of deterrence in the existing regulatory system. Despite the stated objective of the system, the discussion shows that it has not thereby turned the Securities and Futures Commission to pursue an enforcement strategy characterised by an emphasis on the threat of sanctions. In fact, even if formal sanctions are deemed necessary, they may target someone other than the wrongdoers to achieve the regulatory objectives. The gatekeeper strategy is one example whose application in Hong Kong's listing market will be illustrated in section E. Section F offers some concluding remarks.

B. Regulation of the Hong Kong Stock Market

Stock market investors in Hong Kong rely primarily on public oversight for their protection. This is because shareholders face serious legal hurdles when commencing litigation,[15] and institutions that facilitate civil lawsuits, notably, conditional fee arrangements and class actions, are absent.[16] The regulatory structure currently in place in Hong Kong was

[15] For a detailed exposition, see Betty M. Ho, *Public companies and their Equity Securities: Principles of regulation under Hong Kong Law* (Kluwer Law International 1998) 777-93.

[16] The topics of conditional fees and class actions have been studied by the Law Reform Commission of Hong Kong which published two respective reports in 2007 and 2012. The Commission considers that conditional fees are not suitable for Hong Kong because, *inter alia*, Hong Kong has no affordable "after-the-event" insurance which is essential to a successful conditional fee regime. On the other hand, the Commission believes that the introduction of a comprehensive regime for class actions would enhance access to justice, and recommends phasing in the implementation of a class action regime by starting with consumer cases. Yet, at the time of writing, the Hong Kong Government has not indicated whether it will accept the recommendation of the Commission. The two aforesaid reports are available at <www.hkreform.gov.hk/en/publications/introduction.htm> accessed 4 December 2013.

established in 1989 as a response to the global equities collapse in 1987.[17] This structure is commonly known as the three-tier regulatory system, which is studied below.

1. The three-tier regulatory system

At the top of the system is the Hong Kong Government. Strictly speaking, it is not accurate to address the Hong Kong Government as a regulator because its role is confined to formulating policy and introducing legislation concerning the financial matters of Hong Kong. The task of day-to-day regulation of the securities industry is left to the two regulators at the lower tiers.[18]

The Securities and Futures Commission (SFC) is the regulator of the second tier. It was established in 1989 as an independent non-governmental statutory body to regulate the securities and futures markets in Hong Kong.[19] The regulatory objectives of the SFC consist of: (a) developing and maintaining competitive, efficient, fair, orderly and transparent securities and futures markets; (b) helping the public understand the workings of the securities and futures industry; (c) providing protection for the investing public; (d) minimising crime and misconduct in the market; (e) reducing systemic risks in the industry; and (f) assisting the Financial Secretary to maintain Hong Kong's financial stability.[20] The SFC oversees all participants in the securities and futures markets of Hong Kong including listed companies, but its regulatory role in relation to listed companies has largely been delegated to the regulator of the third tier, which is Hong Kong Exchanges and Clearing

[17] After the collapse, the Hong Kong Government appointed a committee to review the regulation of the securities industry in Hong Kong. The report of the committee recommended the formation of an independent statutory body to oversee the securities industry, which is now the Securities and Futures Commission. The title of the committee's report is *The Report of the Securities Review Committee on "The Operation and Regulation of the Hong Kong Securities Industry"* (27 May 1988) <www.fstb.gov.hk/fsb/ppr/report/davison.htm> accessed 4 December 2013.

[18] Berry Hsu et al., *Financial Markets in Hong Kong: Law and Practice* (OUP 2006) 67.

[19] Securities and Futures Commission (SFC), "Our role" <www.sfc.hk/web/EN/about-the-sfc/our-role/> accessed 4 December 2013.

[20] Securities and Futures Ordinance (Cap 571) HK (SFO), s 4.

Limited (HKEx).[21] Nevertheless, the SFC is entrusted with a statutory duty to supervise and monitor the activities carried on by HKEx.[22]

HKEx is the holding company of the Hong Kong Stock Exchange, the Hong Kong Futures Exchange and the Hong Kong Securities Clearing Company. As part of the effort by the Hong Kong Government to reform the financial market,[23] the three preceding entities were demutualised and merged under HKEx which became a listed company in 2000.[24] HKEx is the frontline regulator of the listing market. It is required by law to ensure, as far as reasonably practicable, an orderly, informed and fair market.[25] Moreover, HKEx is responsible for approving the listing of issuers and monitoring their subsequent compliance with the Listing Rules. The Hong Kong Stock Exchange has two boards – the Main Board and the Growth Enterprise Market (GEM).[26] Each board has its own Listing Rules prescribing the initial listing requirements and continuous obligations of all issuers in equity securities and debt securities.[27] Nevertheless, the structures and contents of the Main Board and the GEM Listing Rules are very similar. Hence, this paper refers primarily to the Listing

[21] Gordon Jones, *Corporate Governance and Compliance in Hong Kong* (LexisNexis 2012) 36.
[22] SFO, s 5(1)(b).
[23] Hong Kong Government, "Reinforcing Hong Kong's Position as a Global Financial Centre" (July 1999) <www.webb-site.com/codocs/HKEx-ReinforcingHK990708.doc> accessed 4 December 2013. There are however doubts about whether demutualisation is really necessary and can enhance the competitiveness of Hong Kong in the global market. See, eg, Betty M. Ho, "Demutualization of organized securities exchanges in Hong Kong: The great leap forward" (2002) 33 *Law and Policy in International Business* 283.
[24] HKEx, "Company profile" <www.hkex.com.hk/eng/exchange/corpinfo/profile.htm> accessed 4 December 2013.
[25] SFO, s 63.
[26] The Growth Enterprise Market (GEM) was launched in 1999 to offer access to public capital for emerging companies which are unable to fulfil the listing requirements of the Main Board. See GEM, "The Market for Growth Enterprises" <www.hkgem.com/aboutgem/e_default.htm> accessed 4 December 2013. Yet its positioning has changed in recent years to serve increasingly as a stepping stone to the Main Board, and GEM companies are therefore encouraged to grow and actively prepare themselves for transfer to the Main Board. HKEx, *Consultation Paper on the Growth Enterprise Market* (July 2007), 2 <www.hkex.com.hk/eng/newsconsul/mktconsul/Documents/cp200707e.pdf> accessed 4 December 2013.
[27] The full title of the Main Board Listing Rules is the "Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited" whereas that of the GEM Listing Rules is the "Rules Governing the Listing of Securities on the Growth Enterprise Market of the Stock Exchange of Hong Kong Limited." Both are available at the website of HKEx <www.hkex.com.hk/eng/rulesreg/listrules/rulesandguidelines.htm> accessed 4 December 2013.

Rules of the Main Board to illustrate the relevant requirements unless there is a major discrepancy between the Listing Rules of the two boards.[28]

2. Chinese listings and market regulation

One of the most significant developments in Hong Kong's stock market during the past two decades is the influx of Mainland Chinese companies. "Mainland Chinese companies", "Mainland companies" or "Mainland enterprises" are terms used by Hong Kong regulators to refer to companies based in Mainland China while maintaining a listing status in Hong Kong. They include all Chinese issuers that have listed in Hong Kong in the form of H-share companies, Red-chip companies and Mainland private enterprises.[29] The number of Mainland Chinese companies in the stock market of Hong Kong has been increasing continually since the beginning of their listing in the early 1990s. This trend is displayed more clearly in Table 1. It can be seen from Table 1 that as at the end of 2012, Mainland companies represented 47 percent of the total number of listed companies in Hong Kong and constituted 57 percent of the total market capitalisation.[30]

[28] For an overview of some significant differences between the two sets of rules, see Jones (n 21) 88.
[29] According to the definitions given by HKEx, "H-share companies" are enterprises that are incorporated in the Mainland which are either controlled by Mainland government entities or individuals. In contrast to H-shares, both "Red-chip companies" and "Mainland private enterprises" (known as "non-H share Mainland private enterprises" before 2012) are companies incorporated outside the Mainland. Yet Red-chips are controlled by Mainland government entities whereas Mainland private enterprises are controlled by Mainland individuals. See HKEx, "Market statistics 2012," 13 <www.hkex.com.hk/eng/newsconsul/hkexnews/2013/Documents/130115news.pdf> accessed 4 December 2013.
[30] Ibid 14.

Table 1 Number and Market Capitalisation of Mainland Companies in Hong Kong[31]

Year	No. of Mainland Companies	Percentage of Total No. of Issuers in the Market	Market Capitalisation of Mainland Companies (HK$ billion)	Percentage of Total Market Capitalisation
2012	721	47%	12,597.78	57%
2011	640	43%	9,723.75	55%
2010	592	42%	11,935.77	57%
2009	524	40%	10,443.75	58%
2008	465	37%	6,160.91	60%
2007	439	35%	12,049.01	58%
2006	367	31%	6,714.46	50%
2005	335	30%	3,192.09	39%
2004	304	28%	2,020.45	30%
2003	249	24%	1,679.69	30%
2002	216	22%	982.35	27%
2001	168	19%	1,049.17	27%
2000	142	18%	1,308.65	27%
1999	124	18%	1,005.30	21%
1998	112	16%	372.81	14%
1997	101	15%	522.42	16%
1996	71	12%	295.44	8%
1995	60	11%	127.59	5%
1994	57	11%	104.74	5%

[31] The statistics are collected from HKEx, "Market statistic 2012", "Market statistics 2011" and "Market statistics 2004" <www.hkex.com.hk/eng/index.htm> accessed 4 December 2013. They include all Mainland companies listed on both the Main Board and the GEM.

It is not surprising to find that Hong Kong is the most preferred listing venue for Mainland companies seeking to list abroad.[32] Besides its geographical proximity and close cultural affinity to the Mainland,[33] Hong Kong offers many other advantages to Chinese issuers. The market of Hong Kong is deep and liquid, with a wide range of financial products for investments. Its investor base is broad, which comprises a healthy mix of institutional and retail, local and overseas investors.[34] In addition to a strong concentration of professionals and service-providers that adopt practices at international standards, Hong Kong also commands a sound legal and regulatory system.[35] Quite a number of studies have argued that some (if not all) Mainland companies have improved their corporate governance[36] and enjoyed share premiums by subjecting themselves to the regulatory regime of Hong Kong.[37] Yet whether the influx of Mainland companies into the Hong Kong market has in turn impacted its regulation is a topic that remains unexplored.

[32] It is recorded that as of the end of December 2012, a total of 179 companies incorporated in Mainland China had listed overseas. Among them, 148 are listed on the Main Board (including ten cross-listings in New York, four in London, and one in New York and London) and 28 on the Growth Enterprise Market of the stock exchange of Hong Kong. See China Securities Regulatory Commission, *Annual Report 2012*, 54 <www.csrc.gov.cn/pub/newsite/zjhjs/zjhnb/201307/P020130722553207507219.pdf> accessed 4 December 2013. These figures do not include Mainland companies which were listed in Hong Kong by using overseas-incorporated vehicles.

[33] Joseph Lee and Veronica Chang, "IPO Activities in Hong Kong" (October 2003) SFC Research Paper no.10, 8 <www.sfc.hk/web/doc/EN/research/research/rs%20paper%2010.pdf> accessed 4 December 2013; Erica Fung, "Regulatory Competition in International Capital Markets: Evidence from China in 2004-2005" (2006) 3 *NYU Journal of Law and Business* 243, 273-76.

[34] According to HKEx's statistics of the trading in the securities market during the 12-month period from October 2010 to September 2011, 46 percent of the total market turnover value was contributed by overseas foreign investors, of which 42 percent were overseas institutional investors. Local investors' contribution to the market turnover was 42 percent, with local retail investors and local institutional investors contributing 22 percent and 20 percent respectively. See HKEx, *HKEx Fact Book 2011*, 587 <www.hkex.com.hk/eng/stat/statrpt/factbook/factbook2011/Documents/32.pdf> accessed 4 December 2013.

[35] SFC, "Hong Kong As a Leading Financial Centre in Asia" (August 2006) SFC Research Paper no.33, 4 <www.sfc.hk/web/doc/EN/research/research/rs%20paper%2033.pdf> accessed 4 December 2013.

[36] See, eg, Pamela Mar and Michael N. Young, "Corporate governance in transition economies: a case study of two Chinese airlines" (2001) 36 *Journal of World Business* 280; Laixiang Sun and Damian Tobin, "International Listing as a Mechanism of Commitment to More Credible Corporate Governance Practices: The Case of the Bank of China (Hong Kong)" (2005) 13 *Corporate Governance: An International Review* 81.

[37] Hongbo Shen, Li Liao and Guanmin Liao, "Cross-Listing and Bonding premium: Evidence from Chinese Listed Companies" (2010) 4 *Frontiers of Business Research in China* 171; Qian Sun, Wilson H.S. Tong and Yujun Wu, "Bonding Premium as a General Phenomenon" (March 2006) <http://ssrn.com/abstract=890962> accessed 4 December 2013.

The presence of a large group of Mainland companies certainly poses considerable challenges to Hong Kong regulators. Nurtured in Mainland China where the legal system is underdeveloped, corporate governance standards of Mainland companies are generally seen as inferior to those of their Hong Kong counterparts.[38] More importantly, the fact that these companies are operating in the Mainland has created difficulties for Hong Kong regulators to enforce their rules. Although the Hong Kong market has traditionally hosted a large majority of companies incorporated elsewhere,[39] this situation has not raised so much concern in the past because many overseas-incorporated-listed companies are just "pseudo-foreign" companies whose principal activities are in Hong Kong.[40] In contrast, Mainland Chinese companies operate their businesses in the Mainland where their assets and management personnel are also located. The continual increase of their number in Hong Kong's market has put the ability of Hong Kong regulators to enforce their rules across the border to the test. As pointed out by Donald C. Langevoort, cross-border enforcement is always difficult for regulators because investigating and pursuing a case involving subjects located in another jurisdiction requires not only additional cost and time, but also surrendering to some degree control of the case to another regulator whose cooperation is indispensible.[41]

Under the "One Country, Two Systems" constitutional arrangement, Hong Kong remains a separate jurisdiction after its unification with Mainland China in 1997.[42] Although 16 years

[38] Alice de Jonge, *Corporate Governance and China's H-share Market* (Edward Elgar 2008); Sun et al. (n 37).
[39] By the end of 2011, only 204 among the total of 1,496 companies listed on the Hong Kong Stock Exchange had been incorporated locally. See HKEx (n 34) 607-24.
[40] According to the statistics of HKEx in 2011, the number of genuine foreign companies, meaning that they are incorporated and have a majority of their business outside Hong Kong and Mainland China, are only 27. HKEx (n 34) 17.
[41] As such, Donald C. Langevoort maintains that there is a "home bias" in the enforcement of the U.S. Securities and Exchange Commission, which tends to focus its enforcement actions on domestic rather than foreign issuers. Donald C. Langevoort, "Structuring Securities Regulation in the European Union: Lessons from the U.S. Experience" in Guido Ferrarini and Eddy Wymeersch (eds), *Investor Protection in Europe: Corporate Law Making, the MiFID and Beyond* (OUP 2006) 496-501.
[42] Under the Basic Law, Hong Kong is a special administrative region of the People's Republic of China, and enjoys a high degree of autonomy. Aside from preserving the common law system of Hong Kong, the Basic

have already passed, full reciprocity of regulatory and law enforcement assistance between Hong Kong and the Mainland has not yet been achieved. Consequently, if officers of Mainland Chinese companies deliberately evade legal liability by hiding in the Mainland, it would be difficult to enforce the relevant Hong Kong laws against them, whether by private parties or public regulators. Paul Chow, the chief executive of HKEx between May 2003 and January 2010, described this situation vividly:

> . . . we also have to recognise that from time to time there are unscrupulous operators who seek to use the market to raise money from investors, such money then being channelled to purposes other than those stated in the offering document. This is not appropriate and may at times be criminal, but it can happen in any market. If it happens in a company based in Hong Kong, there is the apparatus to deal with it. But if the misdemeanours are perpetrated by Mainland enterprises, there is a potential problem because of current legal arrangements. Directors who disappear back to the Mainland, money transferred to the Mainland, and any remaining assets which are in the Mainland may be beyond the reach of the Hong Kong authorities.
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> Reflecting the One Country Two Systems principle, Hong Kong and the Mainland have separate legal systems. Legal judgements in one system are not recognised or enforceable in the other system. There are good reasons for this legal divide, but it does raise a problem in the circumstances I have described.[43]

The question of cross-border enforcement has long been recognised by Hong Kong regulators as the greatest obstacle to the effective regulation of Mainland Chinese companies. Early in 1993, regulators of both Hong Kong and the Mainland had entered into the Memorandum of Regulatory Cooperation (MORC), which remains the foundation of the cross-border cooperation in securities regulation between the two places at present.[44] However, without the

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Law also provides that the local legislature will continue to enact laws for Hong Kong and its courts will have jurisdiction over all cases in the special administrative region. See the Basic Law HK, arts 2, 8, 18 and 19.

[43] Paul Chow, "Strengthening Corporate Governance in Hong Kong" (*Exchange*, October 2003), 18, <www.hkex.com.hk/eng/newsconsul/newsltr/2003/documents/2003-10-06-e.pdf> accessed 4 December 2013.

[44] The Memorandum of Regulatory Cooperation (MORC) was signed on 19 June 1993 by the SFC and Hong Kong Stock Exchange on Hong Kong's side, and the China Securities Regulatory Commission, Shanghai Stock Exchange and Shenzhen Stock Exchange on the Mainland's side. By the MORC, regulators of Hong Kong and the Mainland agree to cooperate in (a) enhancing the protection of investors and to maintain market order; (b) ensuring compliance with each party's relevant laws and rules; and (c) facilitating consultation and cooperation by means of regular liaison and exchange of personnel. A copy of the MORC can be found in Larry Kwok,

support of a system of comprehensive mutual legal assistance, the ability of the MORC to combat securities frauds is restricted, and there are from time to time incidents in which enforcement actions initiated by Hong Kong regulators are bogged down by failures to obtain help from the other side of the border.[45] Martin Wheatley, the former Chief Executive Officer of the SFC, aptly summarised the situation:

> The unpalatable fact remains that without full reciprocity of regulatory and law enforcement assistance between Hong Kong and the Mainland, and without reciprocal recognition and enforcement of civil judgments[46] and the mutual transfer of fugitives between our jurisdictions, the SFC's capacity to take effective enforcement action in cases with a dominant "China Factor" is seriously impaired. The inability to have investigations conducted in the Mainland translates into a lack of evidence with which to support prosecutions or enforcement action in Hong Kong, and this should be recognised.[47]

In short, the dominance of the Hong Kong market by Mainland Chinese companies and the related enforcement problems have set a very important context for understanding how Hong Kong regulators devise their enforcement strategy.

C. Complementing Informal Sanctions with Compliance-based Measures

As the frontline regulator of the listing market, HKEx is responsible for administering the Listings Rules which form its principal regulatory tool. In Hong Kong, the internal management of a company is primarily governed by the law in the jurisdictions where it is incorporated. As such, the Listing Rules assume a particularly important role in ensuring that

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Peter Amour and Vincent Chan (eds), *Securities Law: Hong Kong SAR and People's Republic of China*, vol 1 (Butterworths Asia 2004-).

[45] Jiangyu Wang, "Regulatory competition and cooperation between securities markets in Hong Kong and Mainland China" (2009) 4 *Capital Markets Law Journal* 383, 401-03.

[46] In 2006, Hong Kong and Mainland China reached an agreement to mutually recognise and enforce a rather restricted group of monetary judgments. For details, see Xianchu Zhang and Philip Smart, "Development of Regional Conflict of Laws: On the Arrangement of Mutual Recognition and Enforcement of Judgments in Civil and Commercial Matters between Mainland China and Hong Kong SAR" (2006) 36 *Hong Kong Law Journal* 553, 559-63.

[47] Martin Wheatley, "The standard of governance required of listed companies and the role the SFC plays in stamping out corporate corruption and management misconduct" (10 May 2006), 8 <www.sfc.hk/web/doc/EN/speeches/speeches/06/mw_060510_icac.pdf> accessed 4 December 2013.

overseas-incorporated companies have standards of shareholder protection equivalent to those provided in Hong Kong.[48] However, there are obvious constraints for HKEx when enforcing the Listing Rules. Since HKEx is not a statutory body, its powers of investigation and sanction are quite limited. The investigative process of HKEx is described as "consensual" in nature because the parties involved act voluntarily and cannot be compelled to respond to enquiries or produce relevant documents.[49] HKEx has to rely on the directors' personal undertakings to cooperate. It is observed that while directors generally cooperate, there are some who do not which results in delays in HKEx taking effective and timely disciplinary actions.[50] Moreover, the Listing Rules are in essence contractual arrangements between HKEx and listed companies. Consequently, although the Listing Rules provide HKEx with a number of sanctions for breaches such as public censures, public statements of criticisms and denial of market facilities,[51] they impose no statutory liability and are commonly perceived to have delivered inadequate deterrence or lacked teeth.[52] To address the problem of inadequate deterrence, reforms were implemented to grant statutory backing to the Listing Rules and allow the SFC to exercise its statutory powers in the sanctioning of breaches. This topic will be discussed in the next section with regard to the enforcement of the SFC. Suffice it to say that the inability of HKEx to impose formal legal sanctions should not be interpreted hastily as conclusive proof of ineffective regulation since the threat of sanctions is not the only way to procure compliance.

[48] If an overseas issuer is incorporated in a jurisdiction where the standards of shareholder protection are below those provided in Hong Kong, HKEx may refuse its listing from application or require it to make the necessary amendments to the company's constitution. See Listing Rules HK (LR), 19.05(1).
[49] HKEx, "Enforcement of the Listing Rules: Powers, Limitations and Initiatives" (*Exchange*, July 2009), 3 <www.hkex.com.hk/eng/newsconsul/newsltr/2009/documents/2009-07-02-e.pdf> accessed 4 December 2013.
[50] Ibid.
[51] LR, 2A.09.
[52] The Financial Services and the Treasury Bureau, *Consultation Paper on Proposals to Enhance the Regulation of Listing* (3 October 2003), 12, <www.fstb.gov.hk/fsb/ppr/consult/doc/erl-e.pdf> accessed 4 December 2013. Although HKEx has the power to suspend dealings in the securities of an issuer or even delist it, this power cannot be used lightly because many innocent minority shareholders are likely to suffer more than the wrongdoers from the suspension or cancellation of listing. Betty M. Ho, "Rethinking the System of Sanctions in the Corporate and Securities Law of Hong Kong" (1996-1997) 42 *McGill Law Journal* 603, 636.

Generally speaking, enforcement strategies can be divided into two main types. The deterrence strategy adopts a confrontational style of enforcement which emphasises prosecuting and penalising rule-breaking behaviour in order to deter future violations.[53] On the other hand, the compliance strategy uses a cooperative and conciliatory approach to secure compliance, as its central objective is to achieve conformity to the law rather than sanctioning its breach.[54] Persuasion, negotiation and education are common tactics that characterise the compliance strategy, and the threat of sanctions is often employed as a last resort.[55] Both the deterrence and compliance strategies have their own strengths and weaknesses,[56] and as a result, scholars have attempted to provide a meaningful blending of these two enforcement strategies. The most well-known example is the enforcement pyramid constructed by Ayres and Braithwaite in their model of responsive regulation,[57] which employs advisory and persuasive measures at the bottom and progressively more severe penalties up the face of the pyramid. Regulators are advised to begin at the bottom of the pyramid to secure voluntary compliance and escalate gradually to more deterrence-oriented measures when encountering reluctant compliers and the recalcitrant. Though highly influential,[58] the enforcement pyramid is not without criticisms. Baldwin and Black, for instance, have pointed out that the pyramid focuses mainly on the compliance performance of the regulated firms, but regulators should also be responsive to some other factors in conducting their enforcement such as the broader institutional environment of the regulatory

[53] Robert Baldwin and Martin Cave, *Understanding Regulation: Theory, Strategy, and Practice* (OUP 1999) 97; Neil Gunningham, "Enforcement and Compliance Strategies" in Robert Baldwin, Martin Cave and Martin Lodge (eds), *The Oxford Handbook of Regulation* (OUP 2010) 121.
[54] Baldwin and Cave, ibid; Gunningham, ibid.
[55] Gunningham (n 53) 122.
[56] An assessment of both strategies is provided by Gunningham (n 53) 122-25.
[57] Ian Ayres and John Braithwaite, *Responsive regulation: transcending the deregulation debate* (OUP 1992).
[58] Peter Mascini notes that the enforcement pyramid is appealing not only to academics but also practitioners who see it as a theoretical endorsement of the professional autonomy to which they aspire. Peter Mascini, "Why was the enforcement pyramid so influential? And what price was paid?" (2013) 7 *Regulation & Governance* 48.

regime and the different logics of regulatory tools and strategies.[59] In fact, regulatory regimes are often more complex than the binary regulator-regulatee assumed by the enforcement pyramid. Therefore, a more holistic enforcement approach which takes into consideration of the possible roles played by other actors in regulatory process is required for making choices between persuasive and punitive measures.[60]

While there is no straightforward answer to the question of how a judicious mix of compliance and deterrence can be achieved, one encounters in realities different combinations of deterrence and compliance elements in most regulatory systems resulting from their particular institutional and legal settings. In Hong Kong, HKEx tries to complement its rather restricted disciplinary powers by employing a variety of compliance-based measures aiming "to encourage voluntary self-compliance with the Listing Rules by listed companies". [61] Nevertheless, aside from responding to its institutional limitations, this enforcement strategy of HKEx owes also to the strong presence of Mainland companies in the market. Robert Kagan and John Scholz have observed that the kind of enforcement strategy adopted by the regulator usually corresponds to its image of the regulatees.[62] If the business firm is portrayed as an amoral, profit seeking organisation whose actions are motivated wholly by rational calculation of costs and opportunities, the regulatory response would focus on strengthening the deterrent effect of enforcement activities by increasing the

[59] Robert Baldwin and Julia Black, "Really Responsive Regulation" (2008) 71 *The Modern Law Review* 59.
[60] For instance, Neil Gunningham et al. observes that some actors in the regulatory process can play the role as "surrogate regulators"; see Neil Gunningham, Peter Grabosky and Darren Sinclair, *Smart regulation: designing environmental policy* (Clarendon Press 1998) 93-134. For an examination of how different actors can be enrolled in a regulatory system, see Julia Black, "Enrolling actors in regulatory systems: examples from UK financial services regulation" [2003] *Public Law* 63. In the Hong Kong context, the enlistment of third-party professionals as gatekeepers of the listing market is discussed in section E of this article.
[61] SFC, *Report on the Securities and Futures Commission's 2009 annual review of the Exchange's Performance in its regulation of listing matter* (December 2009), 11 <www.sfc.hk/web/doc/EN/speeches/public/surveys/09/exchange_audit_report_091229.pdf> accessed 4 December 2013.
[62] Robert A. Kagan and John T. Scholz, "The 'Criminology of the Corporation' and Regulatory Enforcement Strategies" in Keith Hawkins and John M. Thomas (eds), *Enforcing Regulation* (Kluwer Boston, Inc. 1984) 67-95.

certainty and severity of legal sanctions.[63] On the other hand, if corporate law violations are perceived as stemming from mismanagement or the incompetence of managers to monitor subordinates, the regulator will take a role more like a consultant, and seek to be an educational as well as a law enforcement body.[64] The latter view echoes the remarks concerning Mainland Chinese companies made by Paul Chow who believed that education and guidance are the best ways to assist Chinese issuers to adapt to the regulatory environment of Hong Kong:

> [Mainland enterprises] are the main source of new issuers and hence the main engine of our market's growth. Some of these Mainland enterprises are exemplary companies that are well-regarded by international investors, have sound investor relations, and conduct their affairs appropriately within the rules. The great majority of the enterprises give us no regulatory concerns. However . . . [we] have to acknowledge that Mainland China is a developing economy. With the best of intentions, it will be difficult for companies operating in such environment to comply fully with international standards. That is why we are putting effort into the education of directors and promotion of the idea of corporate governance on the Mainland, for example in seminars and conference. I am sure that over time, these efforts will bear fruit.[65]

Consistent with the above remarks, HKEx uses mainly verbal or written guidance, sometimes accompanied with warning or caution letters to deal with minor breaches of the Listing Rules while reserving public sanctions for more serious breaches.[66] The approach is remedial rather than penal in nature, which aims at rectifying wrongs, undoing harms and preventing future breaches. HKEx has issued regularly guidance materials such as Listing Decisions, guidance letters, frequently asked questions (FAQs) and letters to issuers to

[63] Ibid 69-70.
[64] Ibid 80-84. The authors (in pp 74-80) further discern a third image, i.e., business firms as citizens and their non-compliance is some sort of "rebellion" against the unreasonableness of laws. In response, regulators must function as good politicians who are willing to compromise and adjust regulations.
[65] Chow (n 43) 18.
[66] SFC (n 61) 11. HKEx will consider a number of factors to determine whether a breach is serious, for instance, whether the breach has any negative impact on the orderliness and reputation of the market, and whether it has resulted in any prejudice or risk of prejudice to investors. See HKEx, "The Stock Exchange's Strategy for Enforcing the Listing Rules" (*Exchange*, October 2004), 4 <www.hkex.com.hk/eng/newsconsul/newsltr/2004/documents/2004-10-02-e.pdf> accessed 4 December 2013.

provide advice as to the interpretation of the Listing Rules.[67] Although complete statistics of these guidance materials are not available, it is recorded that 284 written guidance letters were issued to listed companies in 2008 whereas the number in 2007 was 245.[68] Moreover, HKEx encourages listed companies, when encountering compliance questions, to seek from it individual guidance on interpretation of the Listing Rules. It appears that HKEx has to deal with at least several hundred such cases each year. While full statistics are again absent, it is recorded that the number of written enquiries on rule interpretation and related matters handled by HKEx was 350 in 2008, 502 in 2009, 430 in 2010, 393 in 2011 and 435 in 2012.[69]

Furthermore, HKEx tries to promote self-compliance through its education programme. Seminars on different aspects of the listing process and regulation are organised from time to time for issuers. In 2010, HKEx organised a series of nine seminars in Hong Kong which attracted over 1,500 participants and two seminars in Beijing which attracted over 350 participants.[70] The next year, HKEx organised a series of ten issuer seminars in Hong Kong on corporate governance rule amendments and practical compliance matters, which attracted almost 1,800 participants.[71] Due to the importance of Chinese listings to the Hong Kong market, these issuer seminars were conducted again in Putonghua in Hong Kong, Shanghai and Beijing in January 2012, attracting about 600 participants.[72] In view of the fact that issuers' cooperation is necessary for successful implementation of HKEx's enforcement strategy, HKEx is conscious of cultivating mutual respect and understanding between the regulator and issuers and other stakeholders through market outreach activities. In 2010, for

[67] SFC (n 61) 12.
[68] HKEx, *Annual Report 2008*, 40 <www.hkex.com.hk/eng/exchange/invest/finance/2008/Documents/2008.pdf> accessed 4 December 2013.
[69] See HKEx, *Annual Report 2009*, 41; *Annual Report 2010*, 38; *Annual Report 2011*, 44, *Annual Report 2012*, 50, <www.hkex.com.hk/eng/exchange/invest/finance/2011finstat.htm> accessed 4 December 2013.
[70] HKEx, *Annual Report 2010* (n 69) 38.
[71] HKEx, *Annual Report 2011* (n 69) 45.
[72] Ibid.

instance, HKEx conducted nine so-called "meet-and-greet sessions" for their Listing staff to meet 148 issuers' representatives and market practitioners at breakfast or lunch meetings in order for better communication to be promoted.[73]

HKEx, in order to enhance the effectiveness of its disciplinary actions, has been as proactive as possible in enforcement work. It is assumed that if breaches of the Listing Rules are detected quickly, timely actions can be taken to minimise their impact.[74] Through its Compliance and Monitoring (C&M) Department, HKEx actively monitors ongoing compliance with the Listing Rules by listed companies. The C&M Department was established in 2004 when HKEx restructured its Listing Division to increase operational efficiency.[75] The purpose of the restructuring is to better target HKEx's resources in areas "which pose the greatest risks to the maintenance of an orderly, informed and fair market".[76] The C&M Department has undertaken a number of activities in the performance of its monitoring function.[77] For instance, it routinely monitors media reports to check if they contain price sensitive information which has not been announced by any listed company as required. The Department also monitors unusual share price movements relating to listed

[73] HKEx, *Annual Report 2010* (n 69)38.
[74] HKEx (n 66) 4.
[75] SFC, *Report on the Securities and Futures Commission's 2005 annual review of the Exchange's Performance in its regulation of listing matter* (13 July 2005), 2 <www.sfc.hk/web/doc/EN/speeches/public/surveys/05/exchange_audit_report_eng_050713.pdf> accessed 4 December 2013.
[76] HKEx, *Annual Report 2009* (n 69) 40. As Julia Black has observed, the concept of risk is becoming a significant organising principle in regulation and public service delivery. In relation to enforcement activities, the so-called risk-based regulation involves the development of decision-making frameworks and procedures by regulators to prioritise their works and resources based on the degree of risk posed to the regulatory objectives. Black further notes that risk-based regulation is more than the drawing of operational rules and procedures, but in some way represents an endeavour to define the parameters of blame and accountability; see Julia Black, "The emergence of risk-based regulation and the new public risk management in the United Kingdom" [2005] *Public Law* 512. For an analysis of the role of risk in regulation, see Julia Black, "The Role of Risk in Regulatory Process" in Baldwin et al. (n 53) 302-48. Apparently, HKEx has adopted a risk-based approach in its investigation and enforcement work. According to the SFC, HKEx prioritises cases in enforcement according to the severity of the breaches so that it can "focus and place more resources on cases with strong public interest and which pose significant regulatory concern"; see SFC (n 75) 16. Unfortunately, HKEx has disclosed very little information about its enforcement philosophy, and it remains unclear how HKEx actually applies the risk-based approach, for instance, concerning the identification and assessment of risks arising in the regulatory process.
[77] The examples here are drawn from SFC (n 75) 10.

companies because these unusual movements may indicate uneven dissemination of price sensitive information. Another important monitoring activity is to vet announcements and circulars of listed companies to ensure compliance with the requirements of the Listing Rules. Finally, the Department is responsible for handling complaints, including initial enquiries into whether there has been any breach of the Listing Rules. If any breach of the Listing Rules is suspected by a listed company and/or its directors, the Department will refer the case to the Enforcement Department for investigation. The importance of the C&M Department's monitoring function is shown by the fact that most breaches of the Listing Rules are thereby spotted.[78] Table 2 below lays out the statistics concerning the monitoring activities of the C&M Department from 2005 to 2012.

[78] HKEx (n 49) 2.

Table 2 Number of Compliance and Monitoring Actions[79]

	2012	2011	2010	2009	2008	2007	2006	2005
Announcements of listed issuers vetted	42,124	32,508	32,099	27,588	20,784	19,025	11,579	11,092
Circular of listed issuers vetted	1,643	1,565	1,782	1,731	2,849	3,048	2,488	2,409
Share price and trading volume monitoring actions undertaken	3,947	4,507	5,091	8,115	8,439	10,083	7,716	6,200
Press enquiries raised	77	156	221	311	536	495	587	835
Complaints handled	604	657	630	599	516	512	252	262
Cases (including complaints) referred to the Listing Enforcement Department for investigation	35	58	59	54	86	90	141	88

[79] HKEx, *Annual Report 2009* (n 69) 40; *Annual Report 2010* (n 69) 36; *Annual Report 2011* (n 69) 43; *Annual Report 2012* (n 69) 49.

Quantitatively speaking, as shown in Table 2, the bulk of the C&M Department's monitoring actions comprise vetting listed companies' announcements. This is a consequence of the disclosure-based approach of HKEx's regulation, which requires listed companies to provide investors the necessary information required to make informed investment choices. In recent years, HKEx has gradually shifted its practice from pre-vetting to post-vetting issuers' announcements[80] for the purpose of cultivating a self-compliance culture among issuers and reducing delays in issuers' dissemination of information to the public.[81] Nevertheless, the change does not alter the basic monitoring character of the vetting actions. When necessary, HKEx will make follow-up enquiries with listed companies after they have published their announcements.[82] If any non-compliance with the Listing Rules is found, HKEx may request remedial measures to be taken by the listed company in question such as making a further announcement to rectify non-compliance with disclosure requirements.[83] The remedial measures will be imposed without prejudice to any disciplinary action. But for serious breaches, HKEx will consider taking appropriate disciplinary action.[84] It should be noted that the C&M Department has continued to fine-tune its post-vetting process such as conducting detailed reviews of those announcements which relate to more significant transactions, or which pose a higher risk of non-compliance.[85]

For serious breaches of the Listing Rules, HKEx will impose two types of public sanction, namely, public censures and public criticisms. These sanctions are intended to

[80] Only announcements or circulars of a few transactions are not required to be pre-vetted. LR, 13.52.
[81] HKEx, *Combined Consultation Paper on Proposed Changes to the Listing Rules* (January 2008), 22 <www.hkex.com.hk/eng/newsconsul/mktconsul/documents/cp200801_e.pdf> accessed 4 December 2013.
[82] HKEx, *Guide on Practices and Procedures for Post-vetting Announcements of Listed Issuers and Handling Matters involving Trading Arrangements prior to Publication of Announcements* (issued on 1 January 2009; updated on 1 January 2010), 4 <www.hkex.com.hk/eng/rulesreg/listrules/listguid/listpp/eppguid/documents/ai_postvet.doc> accessed 4 December 2013.
[83] Ibid 5-7. More about remedial measures will be discussed later.
[84] Ibid 7.
[85] HKEx, *Annual Report 2010* (n 69) 37.

deliver some form of reputational restraint as they reveal the identities of the companies and the directors in breach to the public. It appears that there is no consensus on the effectiveness of these reputational restraints in regulating corporate actors. Betty Ho, for instance, has considered that the financial community of Hong Kong is too large and heterogeneous for effective application of reputational restraints.[86] In discussing the failures of gatekeepers in the Enron case, John Coffee also exposed that reputational capital is unreliable as an incentive for professionals to perform their monitoring role competently.[87] On the other hand, however, there are studies which suggest that reputational sanctions may not necessarily be ineffective. Alexander Dyck and Luigi Zingales found that the average size of private benefits for Hong Kong is far lower than the international average despite the fact that Hong Kong has traditionally relied on sanctions of publicity and shaming in tackling securities violations.[88] Similarly, Benjamin Liebman and Curtis Milhaupt have noted that reputational sanctions, which the China Securities Regulatory Commission borrowed from Hong Kong, can have significant effects on stock price returns and are thus useful in supervising listed companies and their executives.[89] More research works probably have to be conducted before one can ascertain the effectiveness of reputational sanctions. Yet what needs to be pointed out here is that the classification of public sanctions imposed by HKE as "reputational" has missed an important recent development. It is increasingly frequent for HKEx to impose these sanctions and simultaneously require the parties in breach, whether listed companies and/or their directors, to take certain remedial actions.[90] This trend of combining public sanctions with remedial actions is confirmed by the statistics in Table 3.

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[86] Ho (n 52) 625-32.
[87] John Coffee, *Gatekeepers: The Role of the Professions in Corporate Governance* (OUP 2006).
[88] Alexander Dyck and Luigi Zingales, "The Corporate Governance Role of the Media" (August 2002) CRSP Working Paper No. 543, 12 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=335602> accessed 4 December 2013.
[89] Benjamin L. Liebman and Curtis J. Milhaupt, "Reputational sanctions in China's Securities Market" [2008] *Columbia Law Review* 929.
[90] HKEx, *The Listing Committee Report 2007*, 76-77 <www.hkex.com.hk/eng/listing/listcomrpt/Lcreport.htm> accessed 4 December 2013.

Table 3 Number of Public Sanctions with Remedial Actions[91]

	Total No. of Public Sanctions	No. of Public Sanctions with Remedial Actions	Percentage
2012	8	7	87.5%
2011	9	6	66.67%
2010	8	5	62.50%
2009	8	6	75.00%
2008	15	9	60.00%
2007	16	4	25.00%
2006	20	2	10.00%
2005	18	1	5.56%
2004	19	0	0%
2003	8	1	12.50%
2002	7	0	0%
2001	16	0	0%

[91] The statistics reported here are based on the author's calculation and analysis of all public sanctions published between 2001 and 2012 in the "New Releases" section of HKEx's website at <www.hkex.com.hk/eng/newsconsul/hkexnews/2013news.htm> accessed 4 December 2013.

The trend of making remedial actions an integral part of a public sanction arises from the understanding that sanctions should not be confined to punishing past conducts. From the regulator's point of view, compliance with the Listing Rules is an ongoing concern, and there is a need to prevent the parties in breach from committing similar breaches in the future. The application of remedial measures to sanctioning breaches provides listed companies and their management opportunities to learn from their mistakes and make appropriate improvements.[92] It has been mentioned earlier that HKEx views cases of non-compliance more as results of corporate incompetence and deficiencies in governance structure.[93] Consequently, the remedial actions concentrate on rectifying such problems.

There are three main types of remedial action, of which one or more may be prescribed by HKEx at the same time. The first is the retention of an independent professional adviser by the listed company in breach. The job of the adviser is to conduct a thorough review of the company's internal control system and make recommendations for improvement so that obstacles to future compliance can be removed. The adviser must submit a written report to HKEx concerning the company's implementation of the recommendations within a particular period of time.[94] The second type of remedial action is the appointment of a compliance adviser to guide and advise the listed company on compliance matters in relation to the Listing Rules. A compliance adviser must be qualified as a sponsor,[95] and will often be appointed for a period of one to two years.[96] The third type of remedial action is to require directors of the listed company to undergo certain hours of compliance and corporate

[92] HKEx (n 49) 2.
[93] Cf. Kagan and Scholz (n 62) 80-84.
[94] See, e.g., HKEx's public sanctions on Luoyang Glass Company Limited and its directors on 23 April 2008 <www.hkex.com.hk/eng/newsconsul/hkexnews/2008/080423news.htm> accessed 4 December 2013.
[95] See section E.
[96] See, eg, HKEx's public sanctions on Beijing Beida Jade Bird Universal Sci-Tech Company Limited and its directors on 8 August 2008 <www.hkex.com.hk/eng/newsconsul/hkexnews/2008/080108news.htm> accessed 4 December 2013.

governance training. They have to attend courses held by training providers acceptable to HKEx, such as the Hong Kong Institute of Directors and the Hong Kong Institute of Chartered Secretaries. The training should be completed within the prescribed time, and evidence of attendance must be provided.[97] If the director in breach has already resigned from his directorship, HKEx will make the training a prerequisite of his future appointment as a director of any company listed in Hong Kong.[98]

D. Extensive Use of *Ex Ante* Controls

1. Statutory backing to the Listing Rules

Certainly, there are some unscrupulous actors in the market, whose behaviour cannot be effectively monitored by the compliance-promoting measures of HKEx. The provision of statutory backing to the Listing Rules is thus desirable for deterring these actors from engaging in activities that will damage the interests of investors. Three advantages are deemed to be created for facilitating enforcement if some sort of statutory force is given to the Listing Rules:

(1) it creates a positive statutory obligation for compliance;
(2) it allows more effective investigation of a suspected breach; and
(3) it enables imposition of a wider range of statutory sanctions in respect of any proven breach, as well as sanctions that are commensurate with the seriousness of the breach and therefore more effective.[99]

Moreover, the provision of statutory backing to the Listing Rules is believed to be crucial to enhancing Hong Kong's competitiveness in global listing markets:

[97] See, eg, HKEx's public sanctions on Nanjing Panda Electronics Company Limited and its directors on 9 August 2007 <www.hkex.com.hk/eng/newsconsul/hkexnews/2007/070809news.htm> accessed 4 December 2013.
[98] See, eg, HKEx's public sanctions on Travelsky Technology Limited and its directors on 28 September 2009 <www.hkex.com.hk/eng/newsconsul/hkexnews/2009/090928news.htm> accessed 4 December 2013.
[99] The Financial Services and the Treasury Bureau, *Consultation Paper on Proposals to Enhance the Regulation of Listing* (3 October 2003), 13-14 <www.fstb.gov.hk/fsb/ppr/consult/doc/erl-e.pdf> accessed 4 December 2013.

> In Hong Kong, market participants and the public have expressed increasing concerns about the lack of regulatory teeth in the Listing Rules. Many believe it would hinder our continued development as an international financial centre and the premier listing centre for Mainland China. The success of Hong Kong depends on the quality of our market, the maintenance of which, in turn, requires credible rules that are capable of proper enforcement.[100]

Discussions about granting statutory backing to the Listing Rules have been going on throughout the previous decade.[101] It was once thought that the enactment of the Securities and Futures Ordinance (SFO) in 2002[102] would codify certain major listing requirements in the Listing Rules.[103] However, as it turned out, only a very limited form of statutory backing to the Listing Rules was granted through the introduction of the dual filing system in 2003.[104] Before examining the actual operation of the system, it should be pointed out that although the dual filing system has strengthened the enforcement mechanism in relation to IPO disclosure, its effectiveness in policing ongoing compliance is limited.[105] Notably, it does not impose a positive obligation on listed companies to disclose information, and therefore cannot tackle cases of non-disclosure, late disclosure or selective disclosure of price sensitive or other relevant information.[106] As such, the extension of statutory backing to other requirements of the Listing Rules is deemed necessary. The Securities and Futures (Amendment) Ordinance 2012 was enacted in May 2012 to establish a statutory disclosure regime whereby listed companies are required to disclose price sensitive information in a

[100] SFC, *A Consultation Paper on the Proposed Amendments to the Securities and Futures (Stock Market Listing) Rules* (January 2005), 9 <www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=05CP1> accessed 4 December 2013.
[101] Raymond Chan and John Ho, "Price sensitive information disclosure by listed corporations in Hong Kong: Lessons and experiences from Australia" (2011) 26 *Australian Journal of Corporate Law* 1, 38-57.
[102] It came into effect on 1 April 2003.
[103] Chan and Ho (n 101) 41.
[104] The system was introduced by the Securities and Futures (Stock Market Listing) Rules (Cap 571V) HK (SFSMLR), a piece of subsidiary legislation enacted by the SFC pursuant to s 36(1) of the SFO which took effect on 1 April 2003.
[105] The Financial Services and the Treasury Bureau (n 99) 15.
[106] This weakness is vividly shown in the case of CITIC Pacific which involves the failure of the company to disclose price sensitive information on a timely basis. For a detailed analysis of the case, see Chee Keong Low, "Silence is Golden – The case of CITIC Pacific in Hong Kong" (2009) 39 *Hong Kong Law Journal* 285.

timely manner.[107] The new regime is backed by civil sanctions, including a regulatory fine of up to HK$ 8 million for non-compliance with the requirement.[108] Since the new regime just commenced operation on 1 January 2013, the dual filing regime remains at this stage the only example of statutory backing to the Listing Rules that will allow an in-depth analysis.

2. The dual filing system

The dual filing system requires a listing applicant to file a copy of its application with the SFC apart from HKEx.[109] Further, under the system, a listed company has to file with the SFC its ongoing disclosure materials issued pursuant to the Listing Rules such as public announcements and circulars.[110] To avoid causing an additional compliance burden, a listing applicant or a listed company may authorise HKEx to file the relevant documents with the SFC on its behalf.[111] The rationale of the dual filing system is to back the disclosure regime with effective enforcement so that listed companies have a stronger incentive to make accurate and complete disclosure.[112] The system not only empowers the SFC to object to a listing application containing false or misleading disclosure,[113] but also makes it an offence for any person to knowingly or recklessly provide false or misleading information in a statutory filing with the SFC.[114] Since the disclosure materials are statutory filings with the

[107] A copy of the Securities and Futures (Amendment) Ordinance 2012 is available at <www.legco.gov.hk/yr11-12/english/ord/ord009-12-e.pdf> accessed 4 December 2013.
[108] The Securities and Futures (Amendment) Ordinance 2012 HK, s 307N(d).
[109] SFSMLR, s 5(1).
[110] SFSMLR, s 7(1).
[111] SFSMLR, ss 5(2) and 7(3).
[112] SFC, *A Consultation Paper on the Securities and Futures (Stock Market Listing) Rules and the Securities and Futures (Transfer of Functions - Stock Exchange Company) Order* (May 2002), 2 <www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=02CP15> accessed 4 December 2013; Laurence Li, "Regulation of Corporate Information Disclosure under the Securities and Futures (Stock Market Listing) Rules" (21 March 2003), 1 <www.sfc.hk/sfc/doc/EN/speeches/speeches/03/ll030321_chklc.pdf> accessed 4 December 2013.
[113] SFSMLR, s 6(2).
[114] SFSMLR, ss 5(1) and 7(1); SFO, s 384. In a recent case, the Hong Kong Court of Final Appeal ruled that any document filed with HKEx pursuant to the "dual filing" system constitutes "providing" a copy of the same with SFC within the meaning of s 384(1) of the SFO. See *To Shu Fai v Securities and Futures Commission* (2009) 12 HKCFAR 768.

SFC, the SFC may invoke its powers under the SFO[115] to conduct investigations into suspected cases of breach. If there is sufficient evidence and a prosecution is appropriate, the SFC may do so itself[116] or refer the case to the Department of Justice. Additionally, the SFC may suspend the dealing of the securities of a listed company which has made false or misleading disclosures,[117] for the purpose of maintaining the order and fairness of the market as well as protecting investors.

As the dual filing system has strengthened enforcement at the "backend" (i.e., prosecutions of offenders are possible), it was once predicted that the regulator's burden in pre-vetting disclosure materials would be lessened.[118] However, the actual operation of the dual filing regime has not confirmed this prediction. Since the implementation of the system, a total of six cases of prosecution have been reported.[119] These cases were all related to listed companies' ongoing disclosure, and they were prosecuted pursuant to section 384 of the SFO concerning the provision of false or misleading information. Section 384(1) provides that:

> . . . a person commits an offence if –
> (a) he, in purported compliance with a requirement to provide information imposed by or under any of the relevant provisions, provides to a specified recipient[120] any information which is false or misleading in a material particular; and
> (b) he knows that, or is reckless as to whether, the information is false or misleading in a material particular.

[115] SFO, s 182.
[116] Less serious cases may be prosecuted by the SFC before a magistrate; see SFO, s 388.
[117] SFSMLR, s 8.
[118] Li (n 112) 2.
[119] In these six cases, the offenders were all convicted: (1) Huafeng Textile International Group Ltd. and its director Cai Yang Bo (22 September 2004); (2) Daido Group Ltd. and To Shu Fai (12 April 2007, 4 February 2008, 26 March 2009); (3) Green Energy Group Ltd. and Peter Ko Chung Ting (8 November 2007, 18 November 2009); (4) Asian Capital Resources (Holding) Ltd. and Andrew James Chandler (16 April 2012); (5) Finet Group Limited and its former chairman Mr. Yu Gang (30 November 2012); and (6) PME Group (5 August 2013). Details of these cases can be found according to the date of their press releases on the SFC's website <www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/> accessed 4 December 2013.
[120] This includes the SFC and HKEx; see SFO, s 384(8).

The fact is that a total of six prosecution cases in ten years is a somewhat modest enforcement record, though numbers alone may not tell the whole truth. It is possible that criminal liability is intended to be used rarely, and will chiefly be applied to "the most egregious cases" to achieve a general deterrence effect.[121] But a closer look at the prosecution cases reveals a picture different from what has been suggested. A person who commits an offence under section 384(1) of the SFO is liable, if convicted on indictment, to a maximum penalty of a fine of HK$1 million and imprisonment for two years. The six reported cases, however, were all tried summarily in the Magistrates' Courts, and the maximum amount of fine imposed was HK$100,000.[122] Further, no sentence of imprisonment has ever been imposed; only in one case was the former director ordered to serve 150 hours of community service.[123] The prosecution records lend little support to the claim that the dual filing system has rendered sufficient deterrence to the enforcement of the Listing Rules. Rather, it appears more likely that the regulator is inclined to pursue cases which are relatively simple and have a higher chance of securing a conviction. Such a prosecution policy may owe to the practical difficulties involved in enforcement. As acknowledged by the SFC before the implementation of the dual filing system, enforcing the relevant rules is a challenging task especially when the case bears a cross-border dimension:

> Investigation of disclosure abuse is an inherently difficult task. The complex nature of corporate and financial activities makes building a case a painstaking exercise. Furthermore, most companies listed in Hong Kong have substantial operations outside of the territory; important evidence and witnesses might be unavailable. That the SFC will have to gather sufficient evidence to establish a case to the criminal standard of proof, i.e., beyond all reasonable doubt, will also raise very high the bar for successful enforcement. Nevertheless, the SFC

[121] SFC (n 112) 2.
[122] This amount was imposed in only one case. See SFC, "Asian Capital Resources and its former company secretary convicted of providing false or misleading information" (16 April 2012) <www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=12PR36> accessed 4 December 2013.
[123] SFC, "Former director sentenced for disclosing false or misleading information" (18 November 2009) <www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=09PR163> accessed 4 December 2013.

> is committed to employing all the tools available to it to pursue persons who provide false or misleading information (i.e., lie) to the public and the market . . . In cases involving cross-jurisdiction issues, we will also need to seek the co-operation of fellow regulators overseas under formal memoranda of understanding or informal arrangements.[124]

Despite the SFC's commitment to enforcement, the above remarks underscore the limits to the deterrence approach. In particular, the difficulties in cross-border enforcement, which are frequently associated with Mainland Chinese companies, require the SFC to carefully weigh the costs and benefits involved before taking any enforcement action.

Probably because of the difficulties associated with bringing successful prosecutions, when *ex ante* controls in monitoring disclosures regarding listing applications are available, the SFC has preferred to use them more extensively. The dual filing system empowers the SFC to review and comment on listing applications. If necessary, the SFC may require a listing applicant to supply it further information and may even object to an application that has material deficiencies.[125] The SFC has asserted that the review process does not involve assessment of the merits of an applicant's business activities.[126] Pursuant to the principle of disclosure-based regulation, the purpose of the review is to determine whether timely, accurate and complete information about the company has been disclosed so that the public is able to make informed investment decisions.[127] Initially, the SFC emphasised that with the establishment of the dual filing system, the regulatory focus would move from pre-vetting listing materials to enforcement.[128] Laurence Li, the then Director of Corporate Finance at the SFC, had once stated, "As the Exchange [HKEx] already performs the substantial vetting

[124] SFC (n 112) 7.
[125] SFSMLR, s 6(1) and (2).
[126] SFC (n 112) 6.
[127] Ibid; cf. Li (n 112) 2; SFC, "Smooth Implementation of Dual Filing" (29 May 2003) <www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=03PR129> accessed 4 December 2013.
[128] SFC, ibid.

work, the SFC's involvement will be a matter of reserved power. We will not vet every case."[129] Despite such a claim, it can be seen in Table 4 that the SFC has employed its reviewing power in an extensive manner. Even in the early years of the dual filing regime, roughly speaking, one out of every two listing applications was reviewed and commented on by the SFC. The percentage of applications being reviewed has been on the rise in recent years, reaching as high as 88 percent in the fiscal year of 2011-2012. In view of this, the SFC's involvement in the vetting of listing applications can hardly be regarded as "a matter of reserved power".[130]

[129] Li (n 112) 2.
[130] Ibid.

Table 4 Review of Listing Applications under the Dual Filing Regime[131]

Year	No. of new listing applications received	No. of listing applications reviewed	Percentage of listing applications reviewed	No. of applications rejected, deferred commented upon, withdrawn and lapsed
2012-2013	124	100	81%	15§
2011-2012	191	168	88%	9§
2010-2011	201	160	80%	9§
2009-2010	132	113	86%	2§
2008-2009	87	54	62%	4§
2007-2008	134	93	69%	N/A*
2006-2007	95	58	61%	10#
2005-2006	86	41	48%	11#
2004-2005	122	64	52%	33#
2003-2004	117	54	46%	N/A*

*N/A = not available
§ Cases of deferred comment only
# Include all cases of rejection, deferred comment, withdrawal and lapse

[131] The statistics were collected from the SFC's annual reports and regular updates on the "dual filing" system, which are available on the SFC website <http://www.sfc.hk/web/EN/> accessed 4 December 2013.

When reviewing listing applications, it seems that the SFC has exercised its power to object to an application very rarely. Only on three occasions did the SFC explicitly express its intention to do so, although the relevant statistics are not available.[132] Yet the small number of objection cases should not be interpreted as proving that the SFC's reviewing process is a lax one. The SFC takes very seriously the reviewing work. Two or more rounds of comments are often given to the applicants and their sponsors if the applications are deemed not yet to have attained the expected standards.[133] Sometimes, the SFC may defer raising comments where serious deficiencies are detected in the application, and insist that substantial improvements be made to the listing documents before resuming the review process.[134] Moreover, it is not uncommon for applicants which are unable or unwilling to implement the comments of the SFC to withdraw their application voluntarily, or to have their applications lapsed for failing to respond within the prescribe time. Incomplete statistics of such kinds of cases have been reported by the SFC and are presented in Table 4. To a large extent, the vigorous review process explains why the SFC needs only to exercise its power of objection occasionally.

Although the main objective of given statutory backing to the Listing Rules is to allow the SFC to exercise its statutory powers of investigation and imposition of formal sanctions on cases of breach, it does not follow that the SFC has thereafter robustly pursued every breach of the rules. The examination of the dual filing system has shown that the SFC has a

[132] The SFC explicitly expressed its intention to object to a listing application on three occasions. See SFC, "Update on Dual Filing" (23 October 2003) <www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=03PR233> and "Update on Dual Filing" (15 January 2004) <www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=04PR9> accessed 4 December 2013.

[133] See, eg, SFC, "Update on Dual Filing" (22 July 2003) <www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=03PR233> accessed 4 December 2013, and "Update on Dual Filing" (15 January 2004), ibid.

[134] SFC, "Dual Filing Update" (issue no 1, June 2009) and "Dual Filing Update" (issue no 3, July 2010), 1, <www.sfc.hk/web/EN/published-resources/industry-related-publications/dual-filing-update.html> accessed 4 December 2013.

rather modest prosecution record, probably due to practical difficulties encountered in its investigatory work. Nevertheless, formal sanctions constitute just one of the regulatory tools available to the SFC. Concerning information disclosure in listing applications, the SFC has exhibited a clear preference for *ex ante* measures over *ex post* sanctions to promote compliance.

E. Enlisting of Gatekeepers for Regulation

Even if *ex post* enforcement actions are deemed necessary, their application may not be confined to the wrongdoers. They may instead target third-party professions known as gatekeepers. Gatekeepers are defined as "private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers".[135] Professionals such as lawyers, auditors and underwriters assume a pivotal role in assisting issuers to access the capital market. Due to their commercial relationships with the wrongdoers, gatekeepers enjoy access to information about illegal activities not readily available to public regulators and/or possess special leverage that enables them to detect crimes in more cost-effective ways. Gatekeeper supervision is particularly useful when the primary wrongdoers are difficult to detect and hold liable.[136] In many jurisdictions, lawmakers attempt to conscript gatekeepers into detecting and deferring misconduct by resorting to public sanctions, privately-imposed liability, or both.[137]

Conscious efforts to enlist gatekeepers in the regulation of listed companies are also seen in Hong Kong. Among all gatekeepers relating to activities of listed companies in Hong Kong, sponsors probably have become the most important focus in recent regulatory reforms.

[135] Reinier H. Kraakman, "Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy" (1986) 2 *Journal of Law, Economics, and Organization* 53, 53.
[136] Ibid, 56-57.
[137] Gerard Hertig, Reinier Kraakman, and Edward Rock, "Issuers and Investor Protection" in Reinier Kraakman, et al. (eds), *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2 edn, OUP 2009) 299.

Any issuer seeking to list in Hong Kong must appoint a sponsor to assist it in its application for listing.[138] Sponsors are usually investment banks or other financial institutions appointed by issuers to prepare the listing documents, undertake due diligence work and address all matters raised by HKEx in connection with the listing application.[139] The system of sponsorship was employed to strengthen the regulation of Mainland Chinese companies when the first batch of H-share companies was listed in Hong Kong in 1993. Under the Listing Rules at that time, the requirement to have a sponsor ended once the new applicant was listed although it was recommended that the issuer should retain the services of the sponsor for at least one year following its listing.[140] However, for H-share companies, the retention of sponsors was not only made mandatory but for at least three years.[141] The function of the sponsor after listing was to provide the H-share company with professional advice on questions of continuous compliance.[142] Additionally, it was specified that the sponsor must act as the principal channel of communication between the H-share company and HKEx.[143] The gatekeeper function of sponsor was significantly expanded when the GEM was established in 1999 to enable emerging companies from Hong Kong and Mainland China to raise public funds. Since investing in these companies was believed to be very risky, a strong emphasis was placed on sponsors to instil confidence in the GEM.[144] A set of elaborate rules was imposed upon them to ensure that they would render expert assistance to GEM companies and procure their compliance with the listing obligations.[145] The regulatory

[138] LR, 3A.02.
[139] LR, 3A.11.
[140] LR of 1993, 3.02.
[141] LR of 1994, 19A.05(1). The period was reduced to one year in 1999. See HKEx, "Amendments to the Exchange Listing Rules" (24/4/1999) <www.hkex.com.hk/eng/newsconsul/hkexnews/1999/sehk/990426.htm> accessed 4 December 2013.
[142] LR of 1994, 19A.05(1).
[143] LR of 1994, 19A.05(1) and 19A.06(4).
[144] HKEx, *Consultation Paper on a Proposed New Market for Emerging Companies* (May 1998), 14, 16 <www.hkgem.com/research/e_default.htm> accessed 4 December 2013.
[145] These were originally enclosed in Chapter 6 of the GEM Listing Rules, which was repealed on 1 January 2007.

approach, to some degree, resembled the model of the "Nomads" (nominated advisers) in the AIM (Alternative Investment Market) of London.[146]

The sponsor regulatory regime currently in place in Hong Kong was the result of the comprehensive reform undertaken from 2005-2007. The reform was triggered by the failure of the Euro-Asia Agricultural (Holdings) Company (hereafter Euro-Asia). Euro-Asia was a company specialised in growing orchids in greenhouse facilities established in several provinces of Mainland China. It was listed on the Main Board of Hong Kong Stock Exchange on 19 July 2001. But a year later, the company was found to have falsified financial statements and inflated revenue figures in order to qualify for listing. Additionally, its chairman, Yang Bin, was arrested by Mainland police for committing several serious crimes in Mainland China, including bribery and illegal use of land.[147] He was subsequently convicted and sentenced to jail in the Mainland. After the news of Yang's arrest and the company's allegation of falsifying documents was released, other senior management members of Euro-Asia began to resign from the company and disappeared in the Mainland. This made it very difficult for the Hong Kong authorities to carry out an investigation because Euro-Asia had little physical presence in Hong Kong except the listing shelf, which was ultimately delisted and wound up in 2004.[148] In the end, what had been done was that the

[146] However, there are obvious differences between the two systems. Notably, a Nomad must be retained at all times during the listing of an AIM company whereas after listing, a GEM company is only required to retain a sponsor (in the capacity of a compliance adviser) from the date of its initial listing up to the second full financial year. See LSE, AIM Rules for Companies, pt 1.1 <www.londonstockexchange.com/companies-and-advisors/aim/advisers/rules/aim-rules-for-companies.pdf> accessed 4 December 2013; and GEM Listing Rules, 6A.19. In fact, unlike the AIM where the regulatory oversight of companies listed on it has been largely delegated to the Nomads, HKEx through the GEM Listing Committee is still primarily responsible for regulating issuers listed on the GEM Board. There has been discussion whether the GEM Board should be replaced by another market similar to the AIM, but both HKEx and the SFC are of the view that it is too early for Hong Kong to adopt the AIM model. See HKEx, *Consultation Paper on the Growth Enterprise Market* (July 2007), 2 <www.hkex.com.hk/eng/newsconsul/mktconsul/documents/cp200707e.pdf> accessed 4 December 2013.

[147] Wang (n 45) 402-03.

[148] Pamela Pun, "Wind-up order for Euro-Asia" *The Standard* (Hong Kong, 11 May 2004); HKEx, "Announcement in relation to the matter of Euro-Asia Agricultural (Holdings) Company Limited" (18 May 2004) <www.hkex.com.hk/eng/newsconsul/hkexnews/2004/040518news.htm> accessed 4 December 2013.

SFC instituted disciplinary proceedings against ICEA Capital, the sponsor for the listing of Euro-Asia, for not exercising due skill, care and diligence in the course of performing its duties. Without admission of liability, ICEA Capital settled the case with the SFC by paying the latter an amount of HK$30 million.[149]

Apart from revealing the weaknesses in cross-border regulatory cooperation, the Euro-Asia Incident also highlighted the fact that Hong Kong regulators have few means and resources to detect false disclosure perpetuated by potential listing applicants which are operating outside the territory. Although the Companies Ordinance of Hong Kong has imposed both civil and criminal liability for misstatements in prospectuses on, *inter alia*, directors of issuers incorporated locally or elsewhere,[150] the inadequacies of such *ex post* enforcement measure in protecting Hong Kong investors were shown clearly by the Euro-Asia incident. As a strategy to mitigate the problem, Hong Kong regulators attempt to delegate the task of verifying the accuracy and completeness of prospectuses to sponsors. Sponsors' heavy involvement in issuers' public offerings of securities has placed them in a strategic position to assist the enforcement of IPO disclosures in a cross-border context. As Mark Steward, the head of SFC's Enforcement Division, has pointed out, "In an IPO, if a company, its directors and some of its advisers are all based offshore, the only part of the chain the regulator has the power to influence is the investment banks who underwrite and sell deals to investors."[151]

[149] SFC, "ICEAC Pays HK$30 Million to Settle SFC Disciplinary Case" (27 January 2005) <www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=05PR17> accessed 4 December 2013.
[150] Companies Ordinance (Cap 32) HK (CO), ss 40, 40A, 342E and 342F.
[151] Paul Davies and Brooke Masters, "HK crackdown on trading misconduct" *Financial Times* (London, 20 May 2012) <www.ft.com/cms/s/0/4e6a41e2-a0db-11e1-851f-00144feabdc0.html#axzz2duFbiR00> accessed 4 December 2013.

The reform of 2005-2007 has laid down rules regarding three key aspects of the sponsor regime. The first is about due diligence inquiries. In order that sponsors may undertake due diligence work competently, they are required to follow a detailed practice note[152] which sets out the regulatory standards and provides sponsors with guidance on completing the task. As sponsors' ability to give impartial advice to listing applicants may be impeded by any conflict of interest, the Listing Rules specify a list of circumstances under which a sponsor will not be regarded as independent.[153] HKEx will refuse to accept or vet documents produced by sponsors which fail to satisfy the independence requirement.[154] The second is the extension of the sponsorship concept to the post-listing period. All newly listed companies must appoint a compliance adviser for a "fixed period" after listing – one financial year for listing on the Main Board[155] and two for the GEM.[156] The job of a compliance adviser is, when consulted by the listed company, to provide advice and guidance concerning continuing obligations for listing. A compliance adviser must be a firm eligible under its licence or certificate of registration to act as a sponsor.[157] As mentioned earlier, compliance advisers also play a role in the remedial actions of HKEx. When a listed company is found to have breached the Listing Rules, especially in a serious or persistent manner, HKEx can direct it to appoint a compliance adviser to address any inadequacy in its compliance arrangements or directors' understanding of their obligations under the Listing Rules.[158] It is intended that such measure will increase the chance of voluntary compliance. The final aspect concerns the establishment of a set of eligibility and ongoing requirements for sponsors. Those requirements are intended

[152] LR, Practice Note 21.
[153] LR, 3A.07.
[154] LR, 3A.07, note 1.
[155] LR, 3A.19.
[156] GEM LR, 6A.19.
[157] SFC, *Fit and Proper Guidelines* (Sept. 2006), app I, para II.2 <http://en-rules.sfc.hk/net_file_store/new_rulebooks/h/k/HKSFC3527_548_VER10.pdf> accessed 4 December 2013.
[158] LR, 3A.20.

to ensure that sponsors have sufficient expertise and resources, an effective system of internal supervision, and a clear structure of accountability.[159]

In late 2009, the SFC conducted a review to assess the level of compliance of sponsors. The report published in March 2011 identified certain inadequacies in the work of sponsors. They included unsatisfactory due diligence on listing applicant's business, questionable disclosure to HKEx during the listing application process, failure to maintain proper documentation of due diligence, and inadequate internal systems and controls.[160] The findings of the report led some to believe that the SFC would toughen its stance towards sponsors in the near future. The belief was confirmed by two incidents which took place in 2012. The first incidence was the disciplinary action against Mega Capital (Asia) Company. In April 2012, the SFC revoked the licence of Mega Capital to give advice on corporate finance and fined it HK$42 million for failing to discharge its sponsor duties in relation to the listing of Hontex International Holdings Company.[161] Hontex is a clothes maker based in Fujian province of China, which completed its IPO in Hong Kong in December 2009. Just three months after its listing, the trading of its shares was suspended on the order of the SFC. In addition, the SFC sought an interim injunction from court to freeze the assets of Hontex in an amount representing the net proceeds raised by Hontex from the IPO.[162] The SFC alleged that the prospectus of Hontex contained materially false or misleading information. Though no criminal proceedings have been commenced, the SFC succeeded in seeking court orders against Hontex to make a repurchase offer to investors who subscribed Hontex shares in the

[159] SFC (n 157) app I, para 1.1 - 1.5.
[160] SFC, *Report on Sponsor Theme Inspection Findings* (March 2011) <www.sfc.hk/sfc/doc/EN/speeches/public/surveys/11/Sponsor%20report_FINAL.pdf> accessed 4 December 2013.
[161] SFC, "SFC fines and revokes the licence of Mega Capital (Asia) company Limited" (22 April 2012) <www.sfc.hk/sfcPressRelease/EN/sfcOpenDocServlet?docno=12PR39> 4 December 2013.
[162] SFC, "Court continues interim injunction to freeze assets of Hontex" (8 April 2010) <www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=10PR38> accessed 4 December 2013.

IPO or purchased them in the secondary market.[163] It is not certain whether the SFC will take any further action against Hontex. Nevertheless, the Hontex case is no doubt important from the perspective of the regulation of sponsors. The penalties imposed are by far the heaviest – it is not only the first time that a sponsor's licence has been revoked but the amount of the fine also set a new record.

The second incident was that a few weeks after the licence of Mega Capital was revoked, the SFC published a consultation paper on proposals to tighten the regulation of sponsors and enhance the standards of their work especially in conducting due diligence.[164] The conclusions of the consultation were published in December 2012 with the implementation of some new requirements for sponsors on 1 October 2013.[165] One of the most controversial topics of the consultation is to subject sponsors to civil and criminal liability for untrue statements, including material omissions, in a prospectus. At present, the regulatory regime for sponsors is backed purely by administrative sanctions. It had been proposed in the reform of 2005-2007 that sponsors should be made legally liable, alongside the issuers and their directors, for any misstatement in a prospectus.[166] Legal liability, both civil and criminal, is thought to be useful for increasing sponsors' incentives to ensure the completeness and accuracy of prospectuses. In the end, the proposal was not implemented because of strong opposition from the industry. However, the SFC's determination to extend prospectus liability to sponsors was revealed in the 2012 consultation. Though facing opposition from

[163] SFC, "Hontex ordered to make $1.03 billion buy-back offer over untrue IPO prospectus" (20 June 2012) <www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=12PR63> accessed 4 December 2013.
[164] SFC, *Consultation Paper on the regulation of sponsors* (May 2012) <www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=12CP1> accessed 4 December 2013.
[165] SFC, *Consultation Conclusions on the regulation of IPO sponsors* (12 December 2012) <www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=12CP1> accessed 4 December 2013.
[166] SFC, *Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance* (August 2005), 29-30 <www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=05CP9> accessed 4 December 2013.

the industry as well as law firms, the SFC concludes that it will recommend the Hong Kong Government to revise the relevant provisions of the Companies Ordinance so as to clearly include sponsors in the prospectus liability regime.[167] Since the recommendation involves a law-amendment process and the 2012 consultation provides no specific details of how the relevant amendments should proceed, it is difficult to tell at the time of writing whether sponsors will ultimately be made legally liable for misstatements in prospectuses. Still, both the recent reforms in the sponsor regulatory regime and the Mega Capital case have testified to the adoption of a more vigorous gatekeeper strategy by Hong Kong regulators in overseeing the listing market.

F. Concluding Remarks

This paper argues that neither a light-touch regulatory regime nor an enforcement-led style of public oversight is a correct depiction of the regulation of Hong Kong's listing market. Though the two aforementioned images appear contradictory to each other, they spring similarly from a lack of understanding about the strategy of Hong Kong regulators in enforcing the rules against listed companies. As a former British colony, financial regulation in Hong Kong resembles in some ways the style of the UK where alternative mechanisms are developed to substitute heavy reliance on formal sanctions to procure compliance. Yet, aside from reflecting the British legacy, this paper asserts that the enforcement strategy of Hong Kong regulators is also reinforced by the need to overcome enforcement problems related to Mainland Chinese companies. The increasing presence of these companies in the market has made cross-border enforcement an acute problem for Hong Kong regulators. In particular, the absence of a system of comprehensive mutual legal assistance between Hong Kong and Mainland China set limits on direct deterrence as an enforcement strategy. As shown in this

[167] SFC (n 165) 59. The proposed amendments are related to CO, ss 40A and 342F.

paper, Hong Kong regulators respond to the situation by employing a dynamic mix of different regulatory tools – formal legal sanctions and compliance-promoting measures, *ex post* enforcement actions and *ex ante* controls, direct deterrence and gatekeeper supervision – to try to achieve effective enforcement. It is beyond the scope of this paper to examine whether the current enforcement strategy is optimal. Nevertheless, by examining the different regulatory tools and the manner of their deployment by Hong Kong regulators in tackling non-compliance and modifying the behaviour of corporate actors, this paper hopes to have facilitated a better understanding of the regulatory environment in Hong Kong.