How to Protect the Company?

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Thank you, William, and thank you to the Hong Kong Institute of Directors (HKIoD) for inviting me here to speak. It is truly an honour to be here today.

As many of you know, one of the key areas of the Securities and Futures Commission's (SFC) enforcement work is to investigate and deter corporate fraud and misfeasance in listed companies.

This is a matter of utmost importance to us because repeated incidents of fraud in our listed markets would damage Hong Kong's international reputation and undermine investors' confidence.

Directors play a crucial role in this fight. You are one of the most critical lines of defence within your company. You have the power to oversee the management of your company. You have the power to put in place effective governance frameworks to promote transparency and accountability. And you also have the duty to act in the best interests of your company and its stakeholders. This duty requires you to exercise care, loyalty and good faith in your decision-making.

Because of your seniority and the respect that you naturally attract in your capacity as directors, you are ideally placed to raise red flags and sound the appropriate alarms. You can do this far earlier than external parties, such as auditors and even regulatory authorities like the SFC.

Because of your privileged positions, we take director and senior management failures very seriously. Whenever the circumstances justify it, we strive to hold deliberate bad actors *personally* accountable.

The SFC's Enforcement Division currently has 116 open corporate fraud and misfeasance investigations. While our investigations cover all market segments, we are seeing a rising number of incidents of suspected corporate fraud and misfeasance in small-cap companies.

A substantial proportion of our corporate cases concerns false or misleading financial statements. These include:

- customer and sales falsifications;
- inflating revenue through round-robin transactions;

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- overstating cash balances; and
- understating liabilities such as bank loans.

Other corporate fraud cases involve directors mishandling conflicts of interest and other cases of significantly more serious misconduct aimed at deceiving unwary investors.

These more serious cases include:

- obtaining secret personal benefits from corporate transactions;
- buying overvalued assets to benefit directors;
- causing the listed company to guarantee personal debts of the majority shareholders; and
- most alarmingly, over the past few years, we have seen a trend towards schemes that just blatantly syphon off a company's cash balances.

Duties of a director

If you believe any of these suspicious activities are happening at your company, I strongly urge you to seek expert advice on your duties and liabilities as a director. I would also urge you to do the same if you have not been able to gain access to critical corporate information to do your job properly.

As a director, you must have a deep understanding of your company's business, the industry and the competitive landscape. When you don't fully understand your company's operations or financials, ask questions; when something doesn't make commercial sense, ask questions; when something just doesn't feel right, ask questions—please just ask more questions.

This applies to both executive and *non*-executive directors. In some respects, the independence of a non-executive director grants you the freedom to probe matters that may otherwise seem settled or already resolved.

So what are some *specific* red flags that should pique your interest?

- You may be asked to approve transactions that seem inconsistent with the ordinary business of the company, for example, a mining company acquiring a luxury hotel in an overseas resort;
- you may observe suspicious counterparties in transactions that are clearly not at arm's length;
- you may discover inexplicable movements in the cash balances of the company;
- you may see abrupt changes to the strategic direction of your company without prior consultation of the board, such as a consumer electronics manufacturer entering the money lending business;
- finally, if your auditor resigns, ask questions. If you are part of the audit committee, then you have a particularly strong fiduciary duty to understand why the auditor resigned. This is an area of particular focus to the SFC. We see too many instances where an auditor's resignation is connected to serious corporate misconduct.

If you see any of these red flags, it is in your interest as a stakeholder and your duty as a director to look for reasonable explanations. If they are not forthcoming, you need to act. Raise your concerns with trusted board members, speak to professional advisers, and if appropriate, alert relevant authorities like the SFC.

Importance of a curious mindset

I know it can be hard to detect and prevent sophisticated corporate fraud. It's often perpetrated by a group of bad actors who have a tight grip on the key functions of a company. Usually, by the time the fraud is detected, harm to investors has already occurred.

However, we find that, in many cases, if *just one* director *or senior executive* had acted more proactively and inquisitively, the scale and financial impact of the fraudulent scheme could have been mitigated.

Let's look at one case we investigated. The chairman of a listed company decided to buy an asset from a third party. The seller provided a profit guarantee to the listed company. But when the profit target was not met, giving the company the right to call on the guarantee, the chairman, chief executive officer and chief financial officer together made the extraordinary decision to just forfeit this right, without obtaining the board's approval.

None of the other directors on the board raised any alarm or questions as they were not aware of the profit guarantee in the first place. Had the other directors been more proactive and inquisitive about the management of the company, they would have been aware of the existence of the guarantee. They could then have questioned the decision not to exercise the right. If they had done so, the company would have had a chance to recover at least some of the losses it suffered.

In another case, a listed company, its subsidiaries as well as its controlling shareholder executed non-trade-related fund transfers among each other. These transfers were a result of mere verbal mutual undertakings between a small group of related executives at each level of the corporate group, to provide funding to each other as "working capital". The conflicts of interest should have been obvious. No one documented these verbal arrangements, and no records of any discussions at a board or shareholders' meeting were made.

This is a serious internal control failure to identify and address problems in the management of the listed company. No one raised any concerns about the questionable nature of the fund transfers. Whether this was due to lack of knowledge, lack of awareness or the directors collectively turning a blind eye, shareholders, particularly minority shareholders, relied on directors to take a genuine and professional interest in the company's affairs.

Especially if directors are based elsewhere from the business operations of the company, they must ensure they have the means to access critical transaction and corporate information to effectively discharge their duties. We have seen instances where a series of fraudulent transactions went undetected for an extended period because a single fraudulent director had complete control over the company's bank accounts. The other directors claimed that they had no knowledge of the suspicious transactions because they were based elsewhere from the business operations of the company.

For example, a director based in Hong Kong was able to perpetrate a HK$2 billion fraud against the company. This occurred because two other directors outside Hong Kong, who were responsible for signing or countersigning cheques and documents, were found to have signed them in blank. These other directors did not pay sufficiently close attention to the bank transactions of the company despite being authorised signatories of the accounts. Most of the other board members were also based outside Hong Kong and failed in their duties. Due to this lack of checks and balances, the fraudulent director was able to make payments to fictitious debtors whom he controlled.

So I am appealing to each of you serving as company director, to be *that* person who takes a proactive and inquisitive approach to the position of directorship.

Conflicts of interest

Now, let's discuss the issue of conflicts of interest—an everyday scenario faced by anyone holding a senior position.

In enforcement, we come across these cases far too often. In some instances, we see clearly deliberate acts where greed drove someone to put their personal interests above those of the company. In other cases, the conflict may be more nuanced. I gave an example earlier about the mutual funding of working capital within a corporate group that led to the listed company providing money to its parent without the requisite approvals and documentation.

When acting as a director of a listed company within a corporate group controlled by a separate parent company, the directors should not put the interests of the parent company above that of the listed company. Directors should raise any proposals to this effect as a potential red flag.

If you sit on the board of *both* the parent *and* the listed company, you need to be even more careful in managing any actual or perceived conflicts of interest. If you are unsure about your responsibilities due to a complex situation, you should seek prompt professional advice.

When dealing with conflicts of interest, the board cannot just rely on the personal integrity of individuals. Good corporate governance and culture are critical here. Boards must establish policies to guide individuals on these matters and put in place effective check-and-balance mechanisms to deter attempts to circumvent these policies.

Robust corporate controls do not only protect the company from losses, but may also protect directors from inadvertently breaching their duties as fiduciaries.

Inside information disclosure

Let's now turn to the prompt disclosure of inside information.

We still see incidents of failure to disclose inside information. Part 14A of the Securities and Futures Ordinance (SFO) requires disclosure of inside information to the public as soon as reasonably practicable.

Investors simply cannot make informed investment decisions without timely disclosures of inside information. This undermines investor confidence and harms the reputation of our markets. And it ultimately weakens your companies' abilities to raise capital in our markets.

I should stress that if a listed company intends to rely on the safe harbour in section 307D(2) to withhold the inside information from disclosure, you must ensure that reasonable measures have been taken, and proper safeguards exist within the company to preserve the confidentiality of the information.

SFC's legal toolkit and enforcement approach

Now, I turn to the legal tools we use to combat corporate fraud and misfeasance. These fall into two categories.

First, civil proceedings in which we ask the court to issue compensation or restitution orders, and director disqualification orders. These are under sections 213 and 214 of the SFO. They are largely protective in nature and are designed to allow the SFC to "right a wrong" and protect investors and the market from further harm.

Second, for more serious cases, we can bring criminal actions under section 300 for using fraudulent devices in securities transactions and section 384 for making false and misleading disclosures. Under section 390 of the SFO, we are also able to ask the court to extend criminal liability to officers and *directors* of a company where a company has been found guilty of an offence under the SFO, if the offence is committed with their consent or involvement, or otherwise attributable to their recklessness.

When we see what appears to be criminal behaviour, we will prioritise that case to deliver a strong deterrent message. Criminal actions carry a high evidential burden and demand a disproportionate amount of our enforcement resources, but we will not hesitate to pursue them. In parallel with the strong deterrent message, we prioritise the objective of seeking compensation and restitution for harmed investors.

Our enforcement resources are not limitless, but we vigorously apply all of our available legal tools to protect investors and defend our markets' reputation.

A scan of the horizon

Let me wrap up with a scan of the regulatory horizon from my perspective.

First is the use of technology in regulatory compliance. There are obvious benefits in applying regulatory technologies to improve your companies' internal processes and corporate governance.

But I would caution against jumping head-first at every latest development that comes along like generative artificial intelligence (AI). In fact, I asked an AI Chatbot about this risk, and it responded: "The risks of using generative AI to improve corporate governance include potential biases in the data used to train the algorithms, as well as the risk of relying too heavily on AI-generated insights without fully understanding the underlying data and assumptions, potentially leading to a lack of human oversight and accountability."

So there you have it, from the AI itself.

Next on the horizon is the regulation of virtual asset trading platforms. The new regulatory regime for these trading platforms became effective in Hong Kong in June this year. It provides the SFC with new powers to both regulate these platforms and cooperate with regulatory authorities elsewhere to tackle misconduct arising from the trading of virtual assets. We are closely watching this space to ensure the smooth operation of the new regime and monitor its developments. You may have seen a few days ago that the SFC announced a series of measures to reinforce information dissemination and investor education. One key component of that is to be more transparent about which virtual asset trading platforms have applied for a licence and which ones have not, and which ones are in a kind of interim “deeming” period.

The final item on my horizon is the risk of greenwashing, which refers to false and misleading sustainability disclosures. As Co-Chair of the Green and Sustainable Finance Cross-Agency Steering Group, the SFC is working with the HKSAR Government, Hong Kong Monetary Authority, Hong Kong Exchanges and Clearing Limited and other financial regulators on the implementation of the global sustainability disclosure standards, which were issued by the International Sustainability Standards Board in June.

Although it is still early days, we will be keeping a careful eye on “greenwashing” over the next couple of years.

Closing

In closing, I will stress a few key points:

- Directors should be inquisitive, professional and diligent, act with integrity, and stay consistent with the company’s values, missions and goals.
- Directors have a duty to help implement effective corporate governance and foster a management culture that reduces incidences of fraud and other misconduct.
- Non-executive and independent non-executive directors are critical in providing checks and balances on the boards of listed companies. They should perform their duties with a healthy dose of scepticism and diligence, particularly when evaluating major corporate decisions.
- That’s your job. My job is to hold those who fail to discharge their directors’ duties personally accountable, especially where the company or minority shareholders have suffered harm.

Thank you again to Mr Lo and the HKIoD for having me here today. I am happy to take any questions.