





# We Regulate

In carrying out our regulatory responsibilities we adopt a philosophy of considering the interest of investors first. However, in establishing and maintaining the regulatory environment we aim to achieve an appropriate balance between facilitating the efficient functioning and continuing development of the securities and futures markets and at the same time providing adequate, but not absolute, protection to investors.

## Last year, we

- introduced a new sponsor regime
- published consultation conclusions informing the market of the latest approach to giving statutory backing to certain listing rules
- implemented measures to strengthen the regulation of derivative warrants
- revised the rules on securities margin financing
- successfully prosecuted 51 firms and persons and disciplined 80 licensees or their management
- concluded disciplinary action with an investment adviser which agreed to make record ex-gratia payments to investors

## Regulation

Of each of our primary roles, Regulation, Facilitation and Education it is the first which is our core responsibility and which occupies the majority of our time and effort. As with any regulator, much of our time is spent on day-to-day monitoring, supervising and enforcing activities. However, we are also conscious of the need to constantly review the application of the existing regulatory regime to ensure that it continues to be appropriate for the market which we regulate. In order to do this we work closely with the industry, Mainland authorities and overseas regulators to keep ourselves abreast of regulatory and enforcement issues and international best practices.

From time to time market developments require us to make changes to regulations and changes are also made where opportunities are identified to improve the existing regulatory regime. Where this involves changes in the legislation we need to work with the Government and legislature in order to ensure the passage of new laws. However, there are also occasions where we are able to enhance the regulatory regime by modifying codes and guidelines alone. In these circumstances we will usually conduct a public consultation before implementing any changes.

In considering any changes to rules and regulations we always consider the needs of investors first. However, we also try to put in place rules and regulations that are conducive to market development. We also try to encourage compliance with regulations through selective enforcement action. This is intended to demonstrate to the market that the small proportion of participants who do not conduct their activities appropriately will not profit from their behaviour. We also try and assist market participants comply with regulations by issuing guidance to them through circulars, Frequently Asked Questions (FAQs) and other means.

We are pleased to highlight below some of the major initiatives and actions taken last year in strengthening our regulatory regime.

### Market standards

To enhance the quality of listing, we introduced eligibility criteria and ongoing **requirements for sponsors/compliance advisers** under a new sponsor regime, which became effective on 1 January 2007. Under this new regime, firms have to demonstrate that they have appropriate levels of expertise and meet other eligibility requirements, in order to be confirmed as sponsors, or they will have a licensing condition imposed restricting them from acting as sponsors. As at 31 March 2007, 190 out of the 267 relevant intermediaries had such restrictions imposed; most of these firms had been inactive or had not previously acted as sponsors and indicated to us they did not wish to act as sponsors. The majority of those who wished to continue to act as sponsors have been confirmed although we are still assessing a small number of applications.

For some years there has been a debate concerning how to provide **statutory backing** to certain listing rules relating to the responsibilities of companies listed in Hong Kong. These rules are currently included in a contractual agreement between Hong Kong Exchanges and Clearing Ltd (HKEx) and listed companies, but they have no basis in Hong Kong law. As a result of this, HKEx does not have full investigative powers with which to examine breaches of the Listing Rules. It also lacks a broad range of disciplinary responses to deal with breaches when they occur. In order to provide protection for shareholders, it is necessary that both of these deficiencies are addressed. Within the current structure, the SFC is also unable to properly investigate potential breaches or take action in the event of non-compliance by listed companies with reporting and disclosure obligations under the Listing Rules. This is because the breaches would only be of the Listing Rules which are effectively breaches of a contract with HKEx, and they would not be breaches of the SFO where the SFC can use its investigatory powers.

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On 28 February 2007 we published consultation conclusions on proposed amendments to the Securities and Futures (Stock Market Listing) Rules which would give statutory backing to certain of these listing rules. These rules cover the following three areas: periodic financial reporting by listed companies; disclosure of price sensitive information by listed companies; and shareholders' approval for certain notifiable transactions and connected transactions.

Since then we have been working closely with the Government and HKEx to produce detailed instructions which can be turned into legislation.



We will work closely with the Government to introduce a bill to the Legislative Council to give legal effect to certain listing rules.

Under the **Dual Filing regime**, listing applications and listed company announcements are filed with and reviewed by both HKEx and the SFC to ensure disclosure quality. The SFC raised comments on 58 out of the 95 listing applications received during the year within, on average, seven working days. Of these 58 applications, 22 were listed, 10 were rejected/withdrawn or lapsed, and 26 remained active as at 31 March 2007. We informed the industry of a number of major issues identified by our reviews including: failure to present key information relating to the prospects and sustainability of the business in a fair and accurate manner; deficient disclosure of the relationship between the applicant and its key business partners; and insufficient due diligence by sponsors in relation to the prospectuses.

In March 2006 we proposed measures under a Six-point Plan to enhance the regulation of the **derivative warrants** market in Hong Kong. Rule changes, which facilitated further and identical warrant issues and banned commission rebates and other incentive schemes offered by issuers, came into effect on 30 September 2006. New marketing guidelines also came into effect on 1 October 2006. We are continuing to work with HKEx and the market on proposals to tighten liquidity provider provisions and require the use of plain language and summaries in offering documents.

**Real Estate Investment Trusts** (REITs) became more common during the year with three more REITs being listed. To clarify the potential risks of REITs with special features, we introduced further disclosure requirements for offering circulars to ensure upfront and prominent disclosure of these risks using simple language.

For the past few years the SFC has taken measures to modernise the regulatory regime in the Companies Ordinance (CO) governing the public offering of shares and debentures. On 22 September 2006, we published consultation conclusions with proposals on the way forward for the third and final phase of the **prospectus regime reform**. Key proposals to be pursued included: harmonisation in the regulation of financial products with similar risk and reward exposure; enhancement of investor protection by extending the scope of the prospectus liability regime to offerors, and requiring publication of supplemental prospectus and granting investors withdrawal rights under certain circumstances; and incorporation by reference to make the production of prospectus less costly and more environment- and reader-friendly. We will work with the Government on the proposed legislative amendments to the CO and SFO and will further consult the market when appropriate.

The Takeovers Executive, comprising SFC staff, administers all **takeover** transactions relating to public companies under the Codes on Takeovers and Mergers and Share Repurchases. We comment on takeovers announcements and documents, give rulings and interpretations under the Codes. The takeovers' market in Hong Kong remained very active during the past year with the Takeovers Executive handling a total of 284 transactions. We also commenced a review of various issues that arise under the Codes concerning stock borrowing and lending and hope to consult the market in this regard later this year.

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We worked with the Federation of Share Registrars, the Hong Kong Monetary Authority (HKMA), and the Hong Kong Association of Banks to introduce a new measure, effective from 2 April 2007, to deter **multiple applications** for initial public offerings (IPO). We will continue to work with the industry to identify ways to improve the operation and the integrity of the IPO application process.

Amendments to the financial resources and other related rules, to provide better protection for investors against the pooling risks arising from **securities margin financing**, came into effect on 1 October 2006. There is now a re-pledging limit to cap the maximum amount of client securities collateral that securities margin finance providers can re-pledge to secure their borrowings.

To assist market participants understand our policy requirements and any regulatory changes, we maintain close dialogue and provide assistance with compliance issues. We have also published **circulars and FAQs** on various subjects, including the new sponsor regime, securities margin financing, interpretation of the REIT Code, anti-money laundering and combat of terrorist financing, information security measures for on-line trading, and licensing matters. We also gave talks to members of the Hong Kong Securities Institute and other industry bodies on issues such as preventing misappropriation of client assets and new requirements on securities margin financing. The public and industry are also made aware of matters where we have taken enforcement actions through our monthly publication Enforcement Reporter and other regulatory matters through the bi-monthly newsletter SFC Alert. We also met with compliance officers from the industry in February 2007 to discuss various regulatory and compliance issues.

The SFC has a statutory role to supervise, monitor and regulate the **activities of HKEx** as operator of the stock market and we conduct an annual review of the performance of HKEx in its regulation of listing matters. Our report is made public, after review by the Financial Secretary and is also available on the SFC website. During the year, we reviewed HKEx's procedures in certain key listing-related areas and concluded that the procedures examined were adequate to enable it to discharge its statutory obligation to maintain an orderly, informed and fair

market. However, we also made a number of recommendations to HKEx regarding the transparency of its policies and practices in certain areas. HKEx has already committed to taking appropriate steps to address the majority of the points raised and is considering the remaining issues.

We closely monitor the risks associated with the securities and futures markets. To ensure that we are well prepared for market-wide contingency events, we have put in place a **market contingency plan** which details procedures for dealing with emergency situations that may affect our markets. Last year, we participated in a market-wide contingency rehearsal coordinated by the Financial Services and the Treasury Bureau.

### Regulatory actions

We monitor the activities of the market and intermediaries closely to combat misconduct that jeopardises the interests of investors. We will take firm regulatory actions including disciplinary or legal proceedings against the parties concerned.

We continue to adopt a risk-based approach to the supervision of intermediaries and to encourage licensed corporations to maintain and raise their own standards. One of our key supervisory tools is on-site inspections; routine inspections are



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conducted to assess the general compliance of a firm; theme inspections are held on selected samples of firms with similar activities; and special inspections are targeted at specific firms considered to pose serious or immediate risks to their clients or the market. These inspections also help us identify trends and gaps for policy consideration.

We inspected 136 licensed corporations (65 routine inspections and 71 theme/special inspections) during the year and noted 391 rules breaches where licensed corporations were required to take rectification measures (see further details in Table 6 in the Activity and Market Data chapter). Apart from that, we conducted 154 prudential visits and meetings with management of licensed corporations to discuss the concerns identified and to obtain the latest information about their business operations for our ongoing monitoring purposes. Our inspections and monitoring work found 23 serious breaches which we recommended for investigation and possible disciplinary action.

Among the **theme inspections** conducted this year was a second round of inspections on selected licensed corporations engaged in financial planning and wealth management activities. In reviewing their selling practices and regulatory compliance, we identified deficiencies such as inadequate client and product due diligence and lack of justification of suitability of advice. To address issues concerning the standards of investment advisers, we have issued a set of FAQs for their guidance. The SFC will also continue to take enforcement action against those who committed serious breaches of their obligations.

We conducted a joint inspection with the US Securities and Exchange Commission (SEC) on selected licensed **hedge fund managers** that were also registered with the SEC. The firms inspected were of varying sizes but mainly holding long/short equities with limited use of derivatives and leverage. Both regulators were concerned about the finding that there was inadequate disclosure made of side-letter arrangements, whereby certain investors of a hedge fund are

provided with information and terms that differ from those offered to the majority of the fund's investors, and the extent to which these arrangements might confer material benefits on preferred investors.

During the inspections of brokers last year, we uncovered three cases of **misappropriation of client assets** at Whole Win Securities Ltd, Tiffit Securities (Hong Kong) Ltd and Wing Yip Company Ltd. The total amounts involved were about \$16 million, \$55 million and \$13 million respectively. All three brokers were also found to have failed the financial resources requirements.

In all three cases, we took prompt and decisive action to prohibit those brokers from carrying on business and handling client assets and their own properties. We secured the appointment of administrators by the Court to take control of the firms and worked closely with the administrators to enable the efficient and orderly return of client assets. We also referred these cases to the Police for further investigation.

On Whole Win, we facilitated an agreement between the administrator and a Hong Kong businessman to fund a rescue package which restructured the brokerage so that clients would have their assets returned in full. The process of returning assets to clients was continuing as at 31 March 2007.

In the case of Tiffit, we obtained a prohibition order under which Tiffit's majority shareholder and responsible officer was required to refrain from leaving Hong Kong in order to facilitate the administrators carrying out their duties. We also obtained a Mareva injunction against the majority shareholder and his wife to freeze their assets and banned the majority shareholder from the industry for life. In February 2007, we petitioned for the winding up of Tiffit and secured the appointment of provisional liquidators to preserve the interests of Tiffit's clients.

In Wing Yip's case, the majority shareholder and responsible officer was sentenced to 40 months' imprisonment on 14 December 2006 for theft and false accounting. We

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also banned him from the industry for life. Wing Yip's administrators had returned \$105 million worth of securities to clients by end of March 2007.

We have adopted a three-pronged approach to minimise broker fraud and enhance the protection of client assets held by brokers: first, the continuance of rigorous supervision of brokers to assess their risks and financial positions including, the circularisation of a sample of clients' account balances of selected brokers with the assistance of an audit firm; second, launch of investor education highlighting misappropriation risks; and third, discussion with the Hong Kong Institute of Certified Public Accountants (HKICPA) on how to make more effective use of circularisation of client accounts during annual audits. We have also referred two cases of possible negligence by the auditors of broker firms to the HKICPA and spoken at seminars for their members on securities regulations and audit requirements for licensed corporations.

The SFO provides compensation arrangements to investors who sustain a loss as a result of insolvency, bankruptcy or winding up, breach of trust, defalcation, fraud or misfeasance of an intermediary. The **Investor Compensation Company Ltd** (ICC) administers an investor compensation fund for this purpose. Claims have been received from clients of both Tiffit and Wing Yip and are currently being assessed. As at 31 March 2007, 133 clients of Tiffit had received \$3.36 million from the fund. The SFC will continue to work closely with the ICC on processing the outstanding claims arising from the above cases.

## Enforcement actions

During the year, we continued 448 inquiries or investigations from 2005-06 and opened 620 new ones. We have highlighted in this section some of the most noteworthy cases and issues, and have provided key statistics in the Activity and Market Data chapter.

We employ leading edge software to closely monitor day-to-day trading in the securities and futures markets and identify **unusual price and turnover movements**. This system was upgraded last year to provide enhanced search and analysis features to handle the increasing market turnover. We also search the Internet to detect possible unlicensed dealing, unauthorised advertising of investment services, and other illegal or deceptive financial activities.



We actively monitor media reports and liaise regularly with HKEx on corporate disclosure matters.

During the year, we conducted 191 inquiries into untoward share price and volume movements, 62 cases were investigated further.

We conducted 20 inquiries into suspicious activities in the **derivative warrants** market, including possible false trading, improper fixing of the settlement price during the expiry process, non-compliance with the liquidity provider obligations and illegal short selling. Three cases are under investigation.

During the year, SFC staff gave expert evidence before the Courts or Insider Dealing Tribunal (IDT) on six occasions and assisted in investigations by other law enforcement agencies.

Last year we handled 26 investigations concerning listed companies. We are particularly concerned with cases that raise issues of suspected poor **corporate governance and behaviour**. A significant case that remains under investigation concerns the collapse of Ocean Grand Holdings Ltd and Ocean Grand Chemicals Holdings Ltd. We commenced an inquiry into the affairs of the companies in July 2006 to establish if their business had been conducted for any fraudulent or unlawful purpose. We are liaising closely with the Commercial Crime Bureau (CCB) in its investigations and have also raised this case with our Mainland counterparts.

The SFC has commenced proceedings in the High Court against five former directors of GP NanoTechnology Group Ltd (in liquidation), seeking orders to disqualify them from being directors of or involved in the management of companies. The five persons are alleged to have failed to exercise reasonable skill, care and diligence, and act in the

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best interests of the company. This was the second time an action was taken under SFO section 214 to seek remedies in case of unfair prejudice to the interest of members of listed companies. The first action was against a former director of Riverhill Holdings Ltd who faced similar allegations – the SFC is continuing its preparation for a hearing on this case, expected in mid-2007.

The SFO provides parallel civil and criminal regimes to combat **market misconduct**. A Market Misconduct Tribunal (MMT) has been set up to handle civil cases on six types of market misconduct. These are insider dealing, market manipulation, false trading, price rigging and the dissemination of false or misleading information about securities or futures contracts. During the year, we referred four cases to the Financial Secretary for his consideration of instituting proceedings before the MMT. The cases are currently under review by the Department of Justice.

The Insider Dealing Tribunal (IDT), which will be replaced by the MMT once its cases are completed, concluded six cases in 2006-07. A total of 17 persons were found to be insider dealers in four of the cases and penalties ordered (see Table 7 in Activity and Market Data), while no one was found to be an insider dealer in the remaining two cases. In 2006-07, we continued to investigate 15 cases of suspected insider dealing and opened 14 new ones.

### Prosecutions

In 2006-07, we successfully prosecuted 51 entities, of which four were prosecuted for more than one offence. We offered no evidence against three entities and there were three acquittals after trial. We have provided an analysis of the prosecutions conducted in the section below. More details including the penalties imposed are given in the Activity and Market Data chapter.

- **Market manipulation** undermines the integrity of the market and is a serious offence. We successfully prosecuted two people for manipulating the shares of SIS International Holdings Ltd and VST Holdings, respectively.
- Making unsolicited calls that pressure members of the public to open trading accounts, or to make hasty and often risky investment decisions, is prohibited by the SFO. During the year, seven people were prosecuted for **cold calling**.
- We prosecuted 13 individuals and four companies for carrying on or aiding and abetting the carrying on of

different types of **unlicensed activities**. In addition, four entities were convicted of issuing to the public advertisements or invitations, to acquire an interest in securities or in a collective investment scheme, which had not been authorised by the SFC.

- We also looked into cases of late filing of **disclosure of substantial interests** in listed companies. Minor failures and first time offenders are usually warned with no further action. In 2006-07, HKEx referred 5,176 late filings cases to us, of which 18 were followed by further investigation. We prosecuted six people and seven companies, and issued 96 warnings.
- Anyone attending an interview at the SFC, or providing answers in response to a requirement imposed by an investigator, is under a statutory duty to give complete, accurate and truthful answers. Failure to do so without reasonable excuse is a criminal offence. In 2006-07, five people were convicted of either failing to fulfil this statutory obligation or **misleading the SFC**.
- The SFO prohibits the sale of securities when a person does not have a presently exercisable and unconditional right to sell them. During the year, six people were prosecuted for **short selling**.
- This year, for the first time, we prosecuted a person for **breach of the secrecy provisions** under the SFO. That person disclosed to other people details of an interview with the SFC regarding an investigation. All SFC investigations, inquiries and inspections, are conducted in secret in order to keep confidential the identity of the persons under investigation and to protect the integrity of the SFC's regulatory functions.

### Disciplinary actions

Intermediaries must be honest, competent, efficient and financially sound. A person who has committed an offence, such as those mentioned in the previous section, is liable to prosecution in the courts. A licensee who breaches a non-statutory requirement such as a conduct code provision is on the other hand subject to our disciplinary proceedings which may result in administrative penalties. We take tough disciplinary action against those whose misconduct causes loss or damage to the investing public.

In 2006-07, we took action against 80 licensees or their management. We took no further action in disciplinary

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proceedings commenced against six licensees. Penalty levels have been kept consistent with those in the previous three years, after we raised them in 2003 on the commencement of the SFO. In total, we banned a record 18 licensees, some for life for serious misconduct. We suspended 34 licensees for up to three years and accepted three voluntary undertakings not to conduct certain activities.

Some significant actions were taken during the year against sponsor failure, mis-selling by investment advisers, misappropriation by licensed persons, and lack of internal controls of licensed corporation.

During the year, following a joint action with HKEx, Deloitte & Touche Corporate Finance Ltd refrained from acting as a **sponsor** for nine months for failing to discharge its responsibilities as a sponsor in a listing application. Its responsible officer refrained from acting as a supervisor of sponsorship mandates for six months for failing to adequately supervise his subordinates. We currently have a further three significant actions against sponsors in progress, all of which we hope to conclude in the coming year.

**Mis-selling** continues to be a problem in the industry. During the year, we concluded our largest case to date involving an investment adviser over allegations of mis-selling of funds and concerns about the sale of geared products. The investment adviser, UKFP (Asia) HK Ltd (formerly Towry Law (Asia) HK Ltd), had decided to cease its activities in Hong Kong, limiting the regulatory options that were available to us. Nevertheless, we successfully negotiated a settlement with UKFP (Asia), to make record ex-gratia payments, funded by its holding company, to thousands of affected investors.

The SFC revokes the licences of persons who misappropriate client assets and bans them from the industry for life. Lax **internal controls** and management's failure to supervise staff properly often make misappropriation of clients' assets possible. We are pursuing disciplinary action against a number of companies with lax controls or inadequate management supervision. We aim to conclude these cases in the coming year and send a deterrent message to intermediaries to ensure that they have sufficient internal controls.

We co-operated with HKMA, in the first such joint action, in disciplining Wing Lung Futures Ltd and related parties for unlicensed dealing and aiding and abetting unlicensed dealing. We imposed a suspension of six months, public reprimands, a prohibition order for eight months, and a fine of \$900,000.

More details on the most significant disciplinary actions during the year are given in the Activity and Market Data chapter.

### Securities and Futures Appeals Tribunal

The Securities and Futures Appeals Tribunal (SFAT) is a full-time review body established to ensure that regulatory decisions made by the SFC are reasonable and fair.

During the year, the SFAT dismissed four applications and confirmed the SFC's decisions in these cases.

In one dismissed case, the applicant argued that the SFC was under an obligation to "warn" or "caution" him as to his status as a person under investigation in a disciplinary matter. The SFAT held that there was no privilege against self-incrimination in disciplinary proceedings, and a caution about such proceedings to an interviewee would not serve any legal purpose. The SFAT also held that the SFC was entitled to use the records of prior interviews with the applicant as evidence against him in subsequent disciplinary proceedings.

In another two dismissed cases, the SFAT indicated that usually it would only interfere with the SFC's decision when it was plainly wrong. The SFAT also warned that appellants making unmeritorious appeals would run the risk of costs awarded against them being assessed on a higher than normal basis.

The SFAT also upheld the SFC's decision to refuse a licence application by an individual who had been convicted of using a forged identity card.

In September 2006, the Court of Appeal upheld the decision of the SFAT that affirmed the SFC's decision to suspend a former licensed **investment adviser** for giving unsuitable advice to a client. The Court ruled that it was not sufficient for him to merely talk a client through all the relevant documentation, but that he had to make clear to his client the full picture of the

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investment, including the downside risks of the product, by showing an individualised example of possible loss scenarios. The Court's judgement in this case is a landmark ruling on the duties of investment advisers.

In November 2006 the SFC obtained, for the first time, a **bankruptcy order** against a former licensed person who failed to pay costs awarded by the SFAT following an unsuccessful appeal against an SFC decision. This was followed a month later by another case in which the SFC obtained a bankruptcy order against a person who failed to pay costs awarded to the SFC as a result of an unsuccessful civil action. The SFC recovered indemnity costs from another person involved in the same action.

### Enforcement co-operation with other regulators

We continue to maintain close contact with other Hong Kong law enforcement agencies, our Mainland counterpart, the China Securities Regulatory Commission (CSRC), and overseas regulatory organisations, such as the SEC, in order to combat international financial crime and misconduct. During the year, we provided assistance to a number of overseas regulators concerning enforcement or licensing-related matters and also requested assistance from them on some occasions (see Table 16 in Activity and Market Data for details).

During the year, we referred 13 cases to the Police and three cases to the Independent Commission Against Corruption (ICAC) for further action. We worked closely with the Police particularly in relation to misappropriation of client assets. In February 2007, three former staff of the now liquidated Lawsons Securities Company were sentenced to imprisonment for between 14 and 17 months in a case which was originally uncovered by the SFC and referred to the CCB.

In 2004, we referred a case to the ICAC relating to a former licensee who we banned from the industry for life for stealing clients' securities. On 10 February 2006, that person pleaded guilty to nine counts of theft and one count of conspiracy to pervert the course of public justice and received a custodial

sentence. His solicitor was also convicted of perverting the course of justice by instructing one of her clients to withdraw complaints relating to the licensee's misconduct made to the Police and the SFC, and was also sent to jail.

The Mainland's Securities Law was amended last year to give the CSRC wider investigatory powers to gather evidence on behalf of non-Mainland regulatory authorities, including the SFC. On 30 March 2007, the SFC and the CSRC signed and exchanged side-letters to the Memorandum of Regulatory Co-operation and the Memorandum of Regulatory Co-operation Concerning Futures. Under this arrangement, the SFC may request assistance from CSRC in obtaining information in the Mainland for SFC investigations.



CSRC Chairman Mr Shang Fulin (left) and SFC Chairman Mr Eddy Fong signed the side-letters in Beijing, accompanied by senior officials from the two agencies.