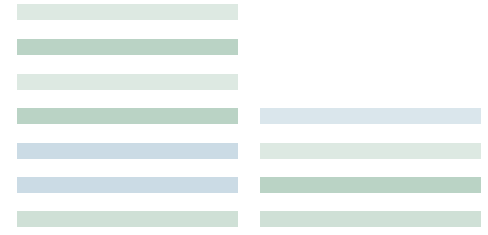


Regulation



Playing a guiding role, like the conductor of an orchestra, the SFC maintains order and quality of the industry. It enforces the laws and provides market practitioners with the necessary guidance to meet the standards expected of an international financial centre.





Regulation

Swings in market volatility and volume provided a dramatic backdrop to the SFC's day-to-day monitoring and supervision roles during the year. We closely monitored the financial integrity, conduct and controls of market operators and intermediaries as global financial uncertainty tested their resilience. However, overall, the market showed a robust ability to cope.

At the same time, our enforcement efforts became more efficient and focused. We made use of the full reach of legislation at our disposal, with our actions targeted at misconduct causing genuine harm to investors and our market.

We continued our long term partnership with the Government and HKEx in considering improvements to the overall regulatory framework. The SFC also worked closely with market players for input and feedback and maintained strong relationships with overseas regulators. Ties with the Mainland authorities have been bolstered and deepened to meet the challenges of cross-border regulation.

Below are some of the major initiatives and action we took to monitor the market, enforce our regulations, strengthen our regulatory regime and address public concerns.

Monitoring the market

The activities of the market and intermediaries were kept under close monitoring during the year as volume, volatility and latterly market downturns added stress to their operating environment. Our goal is not just to ensure compliance with regulatory obligations but also to identify risks and fortify the market and intermediaries to ensure that they have sufficient resilience in the event of adverse market conditions. Among the monitoring measures we took to ensure the integrity of players were the following:



Surveillance work helps maintain a fair and orderly market.



We thoroughly investigate apparent misconduct.

- We enhanced monitoring of the financial integrity of licensed corporations by carrying out intensive and focused risk assessments and required rectification actions where deficiencies in risk management were identified. We also issued circulars to the industry reminding them to tighten their risk management amidst market volatility.
- We conducted nearly 200 prudential visits and meetings with licensed corporations to discuss their business operations. We also conducted risk-based, on-site inspections of 136 licensed corporations to assess their level of regulatory compliance. 460 rule breaches and control deficiencies were identified from these inspections. A further 88 reports of breaches were received from licensed corporations and other external sources. Licensed corporations were required to take rectification measures where deficiencies were identified, including, where appropriate, commissioning reviews by independent accountants. 16 cases of more serious breaches required further investigation.
- We undertook a market-wide risk monitoring exercise in August 2007, including direct enquiries with key market players, fund managers and prime brokers, to gauge the local impact of the subprime crisis in the US and changes in global credit risks on licensed corporations.

Our Dual Filing team continued to play a valuable gate-keeping role in reviewing listing applications under the dual filing regime. Our team identified various areas of concern with applications during the year and highlighted these to sponsors and legal advisers through the publication of regular press releases. We also identified instances of disclosure of false or misleading information by listed issuers through our on-going monitoring of press reports and announcements.

Our Takeovers team handled 99 transactions which included general offers, privatisations and share repurchases and 258 applications under the Codes on Takeovers and Mergers and Share Repurchases (Codes). The Takeovers Panel met 11 times to consider disciplinary proceedings, to rule on matters relating to the Codes and to review proposed amendments to the Codes. The Takeovers Executive took disciplinary action in two cases relating to breaches of the Codes.

Action taken against misconduct

The SFC saw a number of enforcement firsts during the year, reflecting our determination to make full use of the spectrum of legal powers and remedies at our disposal. These firsts included:

- The first disqualification order against a listed company director for misconduct. The director was barred from acting as a director for four years, with the Court making it clear that the need for general deterrence is an element in assessing the period of disqualification.



The SFC commences the first criminal prosecution for insider dealing.

Regulation

- The first conviction after trial for false and misleading information under dual filing. The Court found a listed company and its chairman reckless in not ensuring their response to the Stock Exchange was complete, accurate and not misleading.
- The first insider trading criminal proceeding was commenced. This is also the first indictable prosecution made under the SFO. Twelve charges were laid against five people. The case will proceed during 2008.
- The first time we decided to revoke a firm's licence in an action based on serial breaches of compliance obligations.
- The first time we used our injunction remedies to tackle suspected market abuse. In two actions that are on-going, we successfully obtained interim orders freezing assets totalling \$50 million.
- The first jailing under the SFO. A market manipulator was sentenced to six months' imprisonment. Together with suspended jail terms for five other manipulators, these cases reflect the Courts' view of market misconduct as a serious offence and one for which a jail term is within the range of penalties that could be imposed.
- The first application for an order to punish a person for failing to attend an SFC interview without reasonable excuse. The Court found the person to be in contempt and the person was ordered to be committed to prison until he agreed to attend an interview.

.....

The Judge held that "Given [the person's] wilful obstinacy, I think that committal to prison is an appropriate remedy... This being a matter of civil contempt, the duration of [the person's] imprisonment is obviously in his hands. It is open to him to purge his contempt and end his confinement by attending an interview with the SFC's investigator." (The person was subsequently released from prison and complied with a court order to attend the SFC interview.)

.....

We will continue to use the full spectrum of remedies available to us including civil, disciplinary and criminal action to deter wrongdoing and to protect the market and investors. We aim to send a strong message to the market encouraging compliance and high standards of conduct by all participants.

Enforcement activities

Number of inquiries to brokers	3,978
Number of investigations started	205
Number of investigations completed	119
Number of investigations completed within seven months (%)	87 (73%)
Number of persons charged in criminal proceedings	74*
Number of criminal charges laid	372
Number of Notices of Proposed Disciplinary Actions	72
Number of Notices of Final Decision	81
Number of civil cases commenced	9
Compliance advice letters issued	217

* Five of the 74 persons were prosecuted for more than one offence

During the year we issued nearly 4,000 inquiries to brokers as part of our daily surveillance of the market.

A high proportion of the 205 investigations started during the year were concerned with market misconduct reflecting the focus of our attention on matters causing genuine harm to investors and our market. 53 investigations involved suspected manipulation of the market and 37 investigations involved suspected insider dealing.

Criminal charges laid were up 101 per cent (an increase of 68 per cent excluding disclosure of interests charges) with 74 people facing a total of 372 charges. The largest increase was in the area of market misconduct with a total of 126 charges laid against 17 people for market manipulation and insider dealing offences. Our Enforcement team also made substantial progress in reducing investigation time. We are now completing 73 per cent of investigations within seven months, representing a substantial improvement in our efficiency.

We drew a clear bright line in cases of dishonesty by intermediaries, revoking licences of individuals and imposing life bans in seven cases. Firm steps were also taken in cases where traders operated secret accounts. During the year, we issued restriction notices against two firms following the discovery of serious misconduct:

- A restriction notice against Man Lung Hong Securities Limited was issued in August 2007 following discovery of evidence of concealment of misappropriation of client assets by a licensed representative of the firm. Further inquiry revealed that approximately \$35 million of client assets had been misappropriated. We successfully applied to the Court for the appointment of administrators and the granting of Mareva Injunctions against the licensed representative and his wife to protect the clients' assets. The licensed representative received a 40-month jail term from the Court on conviction of 35 counts of stealing. He was also banned for life from re-entering the securities industry.
- In November 2007 we issued a restriction notice against Great Honest Investment Company Limited following the discovery of evidence of unauthorised dealings and other irregularities. We successfully applied to the Court for the appointment of an administrator, the granting of Mareva Injunctions against the majority shareholder and her brother-in-law to prevent the removal of their assets, and an order prohibiting the majority shareholder from leaving Hong Kong.

We adopted a new approach in resolving compliance issues by obtaining undertakings from firms to proactively rectify problems and bolster compliance standards following breaches. If the same compliance problems arise again, in a specified period, the firm agrees that the original disciplinary sanction, which is usually a suspension of licence, will be imposed. This has proved to be an effective approach in reducing misconduct and improving performance and compliance standards.

There have been an increasing number of challenges to our investigating powers by individuals who are subject to our investigations. During the year, we were successful in defeating a number of these challenges.

While dealing with these issues absorbed significant resources, the resulting clarity regarding certain of our investigating powers will be helpful in future investigations by reducing delays to proceedings brought before the Courts or the Market Misconduct Tribunal. The matters clarified by the Courts include:

- A decision to interview a person for false trading, stock rigging and possible market manipulation is not a breach of the Bill of Rights Ordinance, according to a November 2007 Court judgment. The person is appealing and the matter will be considered by the Court of Appeal on 29 July 2008. However, his application for a stay of the Court's judgment was granted reluctantly.

.....

The Judge held that "That reluctance arises because it is becoming apparent that there is a practice developing on the part of persons subject to enquiry by the SFC, to challenge every step of the way by judicial review, and to appeal as far as possible, any decision that goes against such a person. Few of these challenges have had any success."

.....



Investigations have led to action against market misconduct and other breaches of the law.

Regulation

- The validity of a search warrant executed by the SFC in relation to an insider dealing probe was upheld by the Court in a December 2007 judgment.
- The SFC's power to audio record investigation interviews as part of an insider dealing probe was upheld by the Court in October 2007.

.....

The Judge held that "The power to record an interview by audio means is reasonably incidental and necessary to the power under section 183(1)(c) to compel a person under investigation to answer questions. Consequently, in insisting upon an audio recording of an interview, the SFC and its investigators did not act ultra vires".

.....

We also maintained a strong record before the SFAT during the year, including:

- Two decisions by the SFC to impose a condition which restricted companies from acting as a sponsor were upheld. This confirmed our decision that the companies had failed to meet all the eligibility criteria set out in the Sponsor Guidelines, which came into effect in January 2007.
- The SFAT's decision to suspend immediately the licensed activities of Hong Kong Forex Investment Limited pending a hearing about the SFC's decision to revoke its licence.

The characterisation of the SFAT as a civil tribunal was further reinforced by the Court during the year and the requisite standard of proof for disciplinary proceedings was determined.

Keeping market standards high

The SFC continued to play a key role in improving Hong Kong's overall regulatory framework and contributed to the following on-going regulatory reforms during the year:

- We worked together with the Stock Exchange to require publication of online information packs on IPOs – this requires earlier disclosure of information

by IPO applicants to address the apparent inequality of the timing of information dissemination between institutional and retail investors.

- On-going work to overhaul the prospectus regime continued and proposals were refined. We continue to work with the Government to draft the amendment legislation and consult the market. Where appropriate and feasible within the current legislative framework, we will consider ways to expedite the implementation of the proposals. The publication of online information packs is one example.
- Jointly with the Federation of Share Registrars, the Hong Kong Monetary Authority and the Hong Kong Association of Banks, the SFC introduced a new measure to prevent investors from making multiple subscription applications for IPO shares. This became effective on 2 April 2007.
- We commented on a number of consultation papers issued by the Stock Exchange aimed at boosting the effectiveness of market regulation, including: a combined consultation paper on 18 substantive policy issues in January 2008; a consultation paper in August 2007 seeking market views on changes to reporting deadlines and the introduction of quarterly reporting; and a consultation paper in July 2007 regarding the further development of the Growth Enterprise Market to a second board.

In addition, we reviewed the Stock Exchange's performance in the regulation of listing matters during 2006, and published our findings in the report on the SFC's '2007 Annual Review of the Exchange's Performance in its Regulation of Listing Matters'. We formed the view that the operational procedures and decision-making processes reviewed were appropriate to enable the Stock Exchange to discharge its statutory obligation to maintain an orderly, informed and fair market.

We assisted the HKICPA in their review of the professional guidelines for auditors of licensed corporations and the training of their members on conducting audits of brokers.

Guidance to help investment advisers meet the conduct requirements on giving suitable advice, in the form of questions and answers, was issued and posted on the SFC website in May 2007.

Boosting cross-border regulation

The SFC made significant efforts during the year to boost ties with our regulatory peers in the Mainland as it deals with the jurisdictional challenges of cross-border regulation. We had top-level meetings with the China Securities Regulatory Commission (CSRC) and the China Banking Regulatory Commission (CBRC) during the year and sought mutual exchanges of information to assist with our respective regulatory activities on a number of occasions.

In March 2007 a CSRC side letter to the Memorandum of Regulatory Co-operation and the Memorandum of Regulatory Co-operation Concerning Futures was signed. During the year this has proved to be an effective and useful basis for obtaining investigatory assistance and also in developing a framework for joint work on matters of mutual interest and concern.

A Regulatory Co-operation Agreement of Understanding was signed with the China Insurance Regulatory Commission (CIRC) on 27 March 2008. This marked the first regulatory co-operation agreement on the use of Mainland insurance funds outside the Mainland.



We maintain open communication with the investing public.

Addressing public concerns

The SFC is committed to high standards of transparency and accountability and has an open complaints mechanism to deal with public grievances. During the year, we received 1,204 public complaints, of which 248 cases were referred to operational divisions for further assessment and 89 cases were investigated by the Enforcement Division. A further 159 cases were referred to the Stock Exchange or other financial regulators where the subject matter of the complaint fell within their sphere of responsibility.

One of the staff members in our complaint handling unit was a proud winner of the Ombudsman's Awards 2007, organised by the Office of The Ombudsman, for excellence in complaints handling in the public sector.

Statistics of public complaints

Nature of complaints	2007-08	2006-07	% change
Conduct of licensed intermediaries and registered institutions	353	309	14%
Listing related matters & disclosure of interests	351	339	4%
Market misconduct	215	195	10%
Products	27	26	4%
Other financial activities	248	178	39%
Miscellaneous	10	9	11%
Total	1,204	1,056	14%