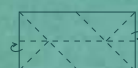
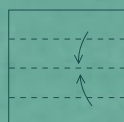
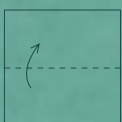
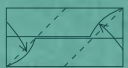
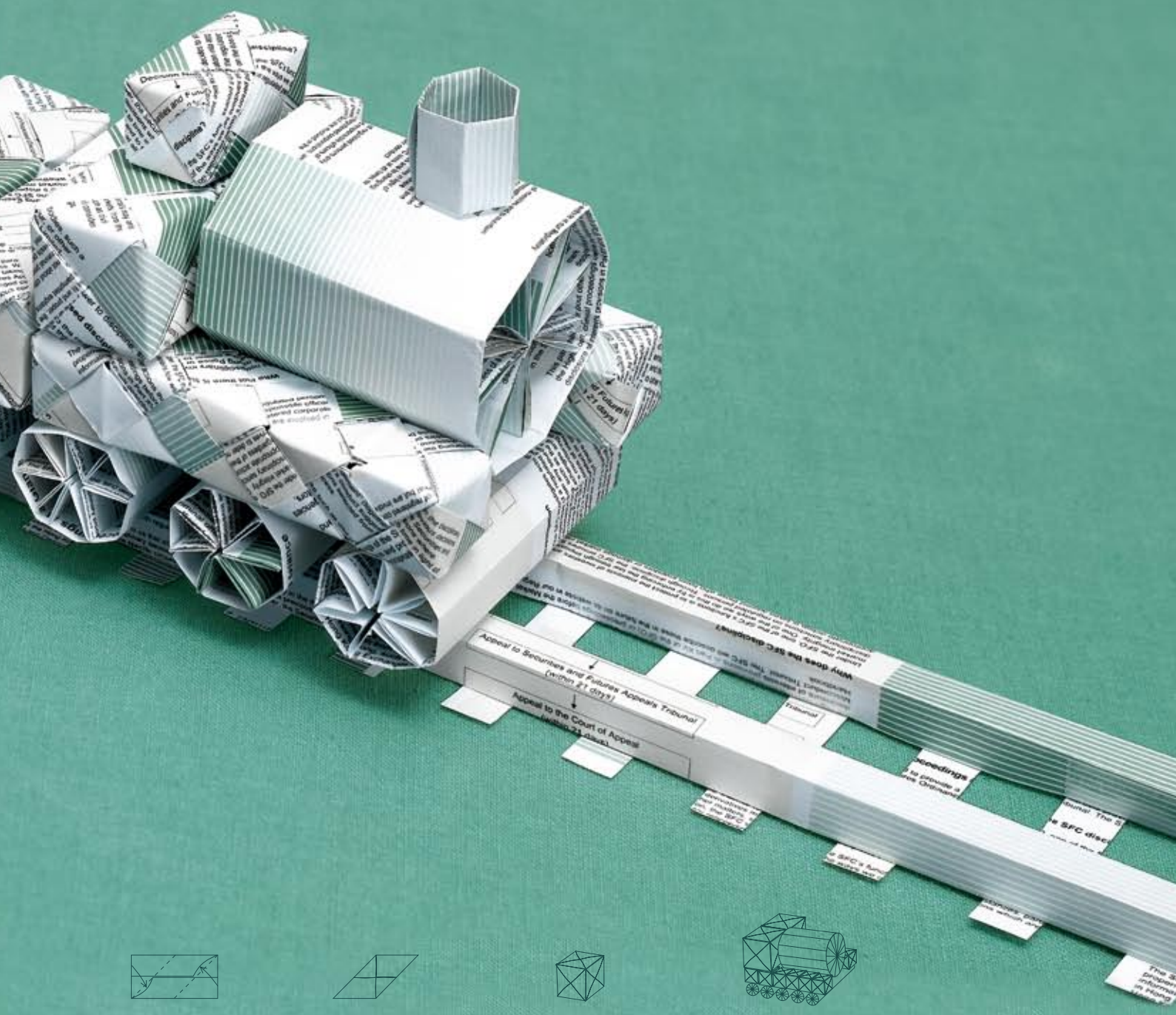




Regulation

A modern rail network operates within a complex system of tracks, signals, switches and controls that allow the whole network to operate smoothly. In much the same way, the securities and futures markets and their participants must operate within a framework of rules and regulations to function efficiently and effectively. This is where the SFC has a clear role – ensuring that the industry and its participants stay on track.





The global financial tsunami has presented new and major regulatory challenges during the year. As the impact of the global economic downturn spread throughout the world, managing risks, addressing misconduct and restoring market confidence became our main priorities.

We applied investigative and disciplinary powers to ensure compliance of intermediaries and orderliness of market activities. We reviewed disclosure requirements in public offers of securities and listened attentively to investor concerns.

Enhancing investigation efficiency

The number of major, complex cases arising directly or indirectly from global, regional and local market events has increased dramatically. We have responded swiftly and aggressively to circumstances that have called for prompt action.

Although we needed to devote considerable resources to a number of major investigations, we still managed to complete 85% of our investigations within seven months, thus meeting our internal commitment to further improve efficiency.

The investigation into Minibond mis-selling complaints has been our highest priority since last September. To resolve approximately 29,000 complaints lodged with the SFC and the Hong Kong Monetary Authority (HKMA) as efficiently and effectively as possible, we have adopted a “top-down” approach, which avoids fragmentation of investigations and claims. This also allows us to address the largest number of complaints within the shortest period of time. Adopting this approach, we examined, among other matters, the selling practices of the intermediaries and registered persons involved, the

intermediaries’ internal controls and systems, training of staff and point-of-sale supervision.

This approach allowed us to complete the first of these investigations within four months. We believe that the outcome of the case was a triple-win formula for the SFC, the intermediary concerned and its clients. Eligible clients of this intermediary were able to receive a return of their capital without going through the uncertainty, expense and time of litigation. Up to \$85 million is being returned to investors. The firm was also sanctioned with a public reprimand and a probationary suspension conditional on their rectifying specified concerns. If similar issues are identified again within a specific time, its licence may be suspended for an agreed period.



Newspapers give wide coverage to the first settlement by an intermediary to all of their Minibond mis-selling complaints.

Similarly, a second Minibond distributor agreed in early April 2009 to a reprimand and to repurchase from its eligible clients all outstanding Minibonds at a value equal to their principal investment.

Our investigations into Minibond mis-selling allegations by more than 20 other distributors are continuing.

In early 2009 we took prompt action to intervene in proceedings commenced by PCCW Ltd for court approval of its privatisation and delisting scheme. This marked the first use of the power to intervene under section 385¹ of the Securities and Futures Ordinance (SFO). We provided the court with evidence relevant to



whether the scheme should be approved and made submissions about the purpose of the voting requirements in the Companies Ordinance, in particular, the legislation's protection of minority shareholders. We interviewed more than 90 witnesses in three weeks, gathering evidence on the conduct, outcome of the shareholders' meeting and circumstances surrounding hundreds of share transfers of single board lots shortly before the shareholders' meeting. We applied for a stay of the order by the Court of First Instance to sanction the scheme within hours of the court's judgment and lodged an appeal two days later. Subsequently, the Court of Appeal ruled in our favour and decided



We collect evidence to investigate alleged vote rigging at PCCW's shareholders' meeting on its privatisation plan.

not to approve the proposed privatisation, stating in its judgment that there was clear manipulation of the vote.

Actions taken to deter misconduct

We have continued the approach, mentioned in last year's annual report, of concentrating our resources on market misconduct. We have further focused our efforts on cases that we consider to be of a more serious nature, including insider dealing. While this has reduced the number of minor cases we have investigated and also our overall case numbers, it has been reflected in the positive enforcement results we have achieved and in the continued improvement of our investigation efficiency.

Following the above strategy we saw a number of enforcement firsts during the year.

- **The first convictions and jail sentences for insider dealing:** The court sentenced two persons to imprisonment

for 26 months and 12 months respectively in the first indictable trial for this offence under the SFO. Three other defendants in the case were ordered to serve significant periods of community service. All five defendants were ordered to pay significant fines, equivalent to the profits they had made by insider dealing. This landmark case demonstrated our determination to use all remedies, including criminal prosecutions, to counter insider dealing. In another case, a listed company manager was sentenced to six months' imprisonment, suspended for two years in recognition of her guilty plea and mitigating circumstances.

- **The first indictable prosecution for market manipulation under the SFO:** Criminal proceedings were brought against four persons for conspiring to manipulate the market for a listed stock, resulting in an inflated market capitalisation of \$4 billion.
- **The first proceedings against executives seeking payment of compensation to the listed companies they oversaw:** We are seeking compensation from a former chairman, a former director and two incumbent directors of a listed company for losses allegedly as a result of their misconduct.
- **The first exercise of our disciplinary power to revoke the licence of a corporation:** We revoked the company's licence, banned its major shareholder from re-entering the industry for life, and prohibited its responsible officer from becoming licensed or registered for three years.

In May 2007, we saw the first disqualification order against a listed company director for misconduct. This year we obtained the second and third disqualification orders issued against two directors for misconduct. They were barred from acting as a director of any company for five years and any listed company for six years respectively.

Continuing the approach we started in 2007/08, we reached an agreement over compliance issues with two ICEA entities. The two ICEA entities were fined a total of \$38 million, the highest fine ever imposed, and they also undertook to engage an independent audit firm to review their compliance systems. A similar material breach within an agreed period could lead to licence revocation.

¹ Under section 385 of the SFO, the SFC may, after consultation with the Financial Secretary, apply to the court to intervene and be heard in proceedings which concern a matter provided for in the SFO or in which the SFC has an interest by virtue of its functions under the SFO, and where the Commission considers it is in the public interest to do so.

Operational Review

The same approach was also used in resolving compliance issues with three Core Pacific-Yamaichi entities and Win Wong Securities Ltd. The outcome achieved with these entities indicated their willingness to take remedial action, embrace good compliance practices and prevent future misconduct.

The Judge held that a disqualification order would be necessary to “.....firstly,..... [protect] the public against the future conduct of persons whose past records as directors of listed companies have shown them to be a danger to those who have dealt with the companies, including creditors, shareholders, investors and consumers; and secondly, [serve as] general deterrence in that the sentence must reflect the gravity of the conduct complained of so that members of the business community are given a clear message that if they break the trust reposed in them they will receive proper punishment.”

Upholding investors’ interests

Firm action was taken in cases where the interests of investors and market integrity were compromised.

- We reprimanded Deutsche Securities Asia Ltd and fined it \$6 million for failing to put in place adequate systems in its facilitation trading programme, a process involving principal-to-principal dealings, to identify and resolve potential conflicts of interest arising from commingled proprietary and client trades.



Team discussions are part of our investigation process.

- We reprimanded Standard Chartered Bank (Hong Kong) Ltd for failing to treat its mutual fund clients fairly. It allowed one client to obtain same-day pricing for switching in and out of the funds while denying other clients the same arrangement, giving them next-day pricing. Our action resulted in the firm agreeing to compensate the disadvantaged clients.
- We reprimanded BOCI Securities Ltd and fined it \$3 million for failing to properly safeguard client securities. For almost a year, its settlement staff used the shares of cash and margin clients to settle transactions for institutional clients who were late in delivering shares for settlement. The fine took into account that no client suffered loss.
- We took prompt action to preserve assets of clients and made an urgent application in the High Court on 12 September 2008 to seek the appointment of administrators over Gartlett Investments Ltd, which we alleged had been conducting an unlicensed business. A court order to wind up the company was obtained on 26 March 2009.
- We reprimanded Macquarie Equities (Asia) Ltd (Macquarie) and fined it \$4 million for failing to exercise due skill, care and diligence in operating a commission rebate scheme for trading in selected warrants issued by Macquarie Bank Ltd. Our investigations found two clients from two brokerages traded heavily with each other in the said warrants with no apparent economic or commercial purpose. They made profits as the commission rebate they received from Macquarie was higher than the brokerage fee they paid to execute these trades.

Enforcement activities

Number of trading inquiries to brokers	2,810
Number of investigations started	208
Number of investigations completed	179
Number of investigations completed within seven months (%)	152 (85%)
Number of persons charged in criminal proceedings	40*
Number of criminal charges laid	128*
Number of Notices of Proposed Disciplinary Actions	53
Number of Notices of Final Decision	50
Number of civil cases commenced	9
Compliance advice letters issued	339

* We brought a total of 128 criminal charges against 40 persons, with 70 charges laid against 15 people for market manipulation and insider dealing.



Under our supervision, the Investor Compensation Co, Ltd (ICC) continued to process claims from clients of three brokerages that went into default in prior years and paid out \$15.94 million in compensation to 219 clients.

In July 2008, the ICC signed a memorandum of understanding with the Hong Kong Deposit Protection Board to facilitate the claim and payment process in the event of default of a bank that is both a member of the Deposit Protection Scheme and a registered institution of the SFC.

Confirming our enforcement decisions

The Court of Final Appeal (CFA) dismissed an individual's application for leave to appeal against the Court of Appeal's judgment, which dismissed the individual's challenge against our power to require him to answer questions in an interview. The CFA's judgment effectively confirmed the use of our investigation powers, which are important tools to help us protect the interests of the investing public and the markets.

The CFA also backed our power to prosecute listed companies and their directors who make false and misleading statements to The Stock Exchange of Hong Kong Ltd (SEHK) under the dual filing regime. An appeal by the former chairman of a listed company against his conviction for providing the SFC with false and misleading information was dismissed, highlighting the importance of listed companies and their directors making accurate and truthful statements to the public through SEHK.

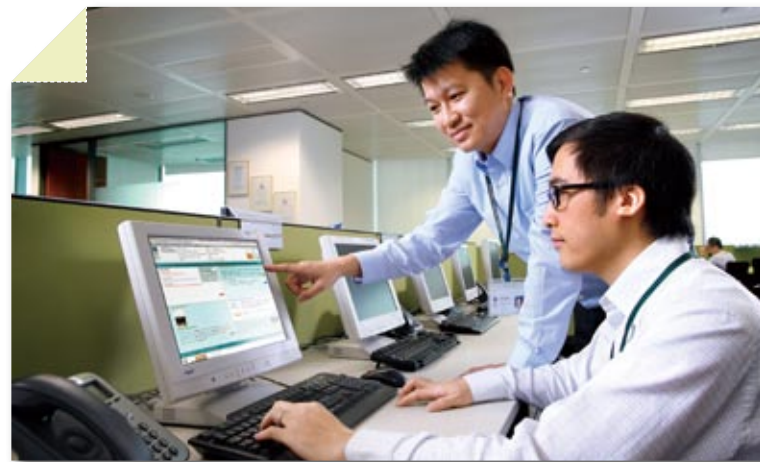
Our position remained strong with respect to appeals to review our disciplinary decisions. During the year, the Securities and Futures Appeals Tribunal upheld the SFC's decisions in seven cases and reduced penalty in three cases.

Monitoring the market

Over the past year, we have closely monitored SFC-authorized collective investment schemes² (CIS) and exchanged information with local and overseas regulators on potential market impact on SFC-authorized funds.

The day after Lehman Brothers (LB) Holding Inc filed for bankruptcy protection in the United States, we issued restriction notices on four licensed LB companies in Hong Kong to preserve their assets and those of their clients. We allowed Lehman Brothers Futures Asia Ltd to conduct an orderly close-out of

outstanding positions, and permitted Lehman Brothers Asset Management Asia Ltd to continue operating, subject to tight monitoring of its compliance with the Financial Resources Rules. We have also been working with Hong Kong Exchanges and Clearing Ltd (HKEx) to identify ways of mitigating the potential impact of any future failure of a major brokerage on HKEx's operations.



We actively monitor the market's trading activities.

Enhancing industry awareness of compliance issues has been a priority for us. We have reminded licensed corporations to strengthen their systems and controls and also to adopt measures to combat money laundering and terrorist financing.

- We conducted two rounds of special reviews of a number of brokerages to assess their securities margin financing practices and risk management controls. We later shared the findings of the first round of reviews with the industry to highlight the need for stricter risk management.
- We reminded intermediaries to implement good supervision and risk management practices and oversight of senior management responsibility, trading controls and reporting of red-flag transactions.
- We shared our findings from a theme inspection of some local hedge fund managers with the industry and highlighted

² Collective investment schemes refer to mutual funds, unit trusts, real estate investment trusts, investment-linked assurance schemes, the Mandatory Provident Fund, pooled retirement funds and paper gold schemes.

Operational Review

our expectations regarding appropriate standards of conduct, risk management and control procedures, valuation of investments, disclosure to investors and operational efficiency.

- We asked intermediaries to conduct a formal self-examination of controls and procedures on suitability obligations and to maintain documentary evidence to show the effective application of such controls and procedures.

We have taken a number of measures to ensure the financial and operational integrity of licensed corporations, including:

- more stress testing of the liquid capital level to assess sensitivity to extreme market conditions;
- 38 special inspections of risky firms with a focus on their compliance with liquid capital requirements;
- 273 meetings with licensed corporations and industry bodies to understand their business operations in the context of the latest market developments; and
- 160 risk-based, on-site inspections of licensed corporations to assess the compliance level of intermediaries. From these inspections and on-going supervision work, we identified 547 infractions of rules and control deficiencies, 24 cases of more serious breaches that warranted further investigation, and seven cases of serious failures for which the licensed corporations were required to appoint external accountants to conduct internal control reviews and/or circularisation of client accounts.

Maintaining high market standards

We conducted two joint seminars with two accounting bodies and shared with their members some common control deficiencies and breaches that were detected in our supervision of brokerages.

In view of the widespread public concern over the offering of retail investment products in the wake of the financial turmoil, we conducted sessions with industry participants in the insurance industry and the fund management industry respectively to provide them with guidance on enhanced disclosure requirements

of offering documents and marketing materials in relation to SFC-authorized CIS. We also reminded all management companies of SFC-authorized funds of their obligation to properly monitor counterparty risks and related risk mitigation.

In light of market volatility last October, the Takeovers and Mergers Panel (Takeovers Panel) considered whether the trigger and creeper provisions in the Code on Takeovers and Mergers should be temporarily relaxed. The Takeovers Panel was opposed to the relaxation as the proposals ran counter to the principle of equal treatment of all shareholders. Separately, it made a recommendation to introduce additional safeguards regarding confirmation of sufficiency of financial resources by financial advisers in code-related transactions.

During the year, we handled 74 transactions, including general offers, privatisations, whitewashes and share repurchases and 192 applications under the Codes on Takeovers and Mergers and Share Repurchases. The Takeovers Panel met eight times to rule on issues relating to live transactions and policy issues.



Staff conduct research for their policy work.

We continued to play a gate-keeping role in reviewing listing applications under the dual listing regime. During the year, we identified two cases involving possible false or misleading disclosure and other public interest concerns, and both applications were withdrawn after the applicants were informed of our concern and the likelihood of our formally objecting to the proposed listings.



We approved the Listing Rules amendments proposed by HKEx, after obtaining affirmative feedback from the public. Of the 15 rule amendments, 14 took effect from 1 January 2009. The proposal to extend the black-out period restricting directors from trading in shares of their listed companies before results announcements was curtailed and implementation postponed until 1 April 2009 in light of subsequent market concerns.

During the volatile period following LB's collapse we increased our monitoring of short selling in Hong Kong and developed contingency plans for additional restrictions should they have been required. We also stepped up surveillance to detect potentially abusive activities in the market. However, while we put on hold the lifting of the uptick rule, a mechanism meant to moderate the stock prices of short-sell orders, we did not feel the need to introduce additional restrictions. Our market surveillance during this period, together with the experience of various overseas markets that imposed significant restrictions on short selling, have subsequently shown Hong Kong's short selling regulations to be well balanced and effective.

There was considerable concern during the year regarding volatility experienced during the new closing auction introduced by HKEx. Following public concern about this volatility and the possibility that price manipulation had taken place, HKEx decided to suspend the closing auction session from 23 March 2009. We supported HKEx's decision due to concerns about any appearance of abuse and the need to maintain public confidence.

Addressing public concern

Last year, we received 10,070 public complaints, a record high, of which 8,252 were on issues related to LB's collapse. We, in turn, referred 7,608 complaints to the HKMA for preliminary review as they pertained to alleged mis-selling by banks.

Our various operational divisions reviewed 908 non-LB related complaints and found grounds to investigate 68 cases. A further 203 were referred to HKEx or other financial regulators as the subject matter fell within their various spheres of responsibility.



Investor leaflets on a wide range of topics are available at the SFC's reception area.

Public complaints overview

Nature of complaints	2008-09	2007-08	% change
Conduct of licensed intermediaries and registered institutions	513	452	14%
Listing-related matters and disclosure of interests	505	434	16%
Market misconduct	422	231	83%
Products	37	14	164%
Other financial activities	294	259	14%
Miscellaneous	47	20	135%
Subtotal	1,818	1,410	29%
Complaints related to Lehman Brothers	8,252	0	N/A
Total	10,070	1,410	