

A bi-monthly communication between the SFC and the market about the SFC's enforcement work and current enforcement issues.

## What Have We Been Doing?

We are committed to reducing crime and misconduct in our securities and futures markets by:

- identifying risky conduct and circumstances that may lead to misconduct; and
- taking necessary enforcement action.

From 1 August to 30 September 2008, we sent 52 compliance advice letters when we became aware of conduct that presented unnecessary risks or which might lead to crime or market misconduct.

During the same period, we also completed 29 enforcement cases (including the issue of one disciplinary notice of decision), commenced five criminal proceedings, took civil action against seven listed company directors (in respect of two listed corporations) and sought the appointment of administrators over one company.

## Lehman Brothers Minibonds Investigations - Focus on mis-selling

We responded swiftly to issues arising from the collapse of US investment bank Lehman Brothers Holdings. We took the rare step of announcing the commencement of formal investigations into the conduct of three SFC-licensed distributors in selling Lehman Brothers Minibonds (Minibonds). We have now announced that we have received a number of referrals from the Hong Kong Monetary Authority (HKMA) concerning possible misconduct identified by the HKMA involving some banks that distributed Minibonds.

We will be conducting a top-down investigation examining whether the sale of these products was the result of any systemic weakness or failure of management controls. This will ensure we are able to deal with the large volume of complaints efficiently, effectively and expeditiously. We will not take short cuts or compromise our objective to get it right.

## Highlights

- From 1 August to 30 September, we completed 29 enforcement cases (including the issue of one disciplinary notice of decision), commenced five criminal proceedings, took civil action against seven listed company directors (in respect of two listed corporations) and sought the appointment of administrators over one company.
- Formal investigations were launched into allegations of mis-selling of Lehman Brothers Minibonds.
- The Securities and Futures Appeals Tribunal endorsed heavier penalties for prevalent, uncompensated misconduct.
- Proceedings were commenced against current and former company directors for alleged misconduct.
- The court appointed administrators over unlicensed futures dealer.

In addition, we are also examining whether any facts, matters or circumstances that should have been disclosed to the SFC were not disclosed to the SFC at the time the offer prospectuses and marketing materials for each series of Minibonds were submitted for vetting.

Given the many issues that have been aired publicly about Minibonds, it is important to clarify what really constitutes mis-selling.

In general there are two major types of mis-selling. First, an investor may be given materially wrong information about a financial product leading him or her to make an investment decision which the person would not have made if the correct information had been provided. The second type occurs when an investor ends up investing in a product that is not suitable given his financial position, investment objectives, expectations and risk tolerance level.

These two major types of mis-selling are addressed directly in the SFC's Code of Conduct for Persons Licensed by or Registered with the SFC which requires banks or SFC-licensed firms to understand the products they are selling and to ensure only suitable products are sold to their clients.

Mis-selling has no bearing on the performance of the investment vehicle. Accordingly, the fact that an investor may have lost money does not mean, by itself, there has been mis-selling.

In a recent speech, Mr Mark Steward, Executive Director of Enforcement, explained the issue of mis-selling. Please follow this link to access the [speech](#).

In addition to launching investigations, we have also issued a circular to intermediaries to remind them of their responsibility to ensure product suitability for clients. Separately, we encouraged intermediaries to accelerate their mis-selling investigations in house.

For further information on the topic, please click the "Lehman Brothers-related issues" icon on the [SFC homepage](#).

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## SFAT endorses higher penalties for pervasive misconduct

On 10 July 2008, the Honourable Mr Justice Stone, Chairman of the Securities and Futures Appeals Tribunal (SFAT), upheld the SFC's decision in the case of Radland International Ltd to publicly reprimand and fine the broker \$1.5 million for internal management control weaknesses. The case concerned the misappropriation of \$6.8 million over a period of eight years.

While the fine imposed was almost twice that of a comparable case for the same type of infraction, the SFAT accepted that it was justified on the grounds that:

- misappropriation of client assets had become a serious problem in recent years;
- the loss to clients was material;
- the period in which the client assets had been misappropriated was long; and
- clients had not been compensated.

The Honourable Mr Justice Stone referred to the *'Disciplinary Fining Guidelines'* gazetted on 28 February 2003, and the SFC publication *'Disciplinary Proceedings at a Glance'* dated 25 September 2005, in which the SFC makes it clear that one of the factors for determining the level of penalty in a particular case is "whether the conduct is widespread in the industry" and that "if the misconduct has become widespread or prevalent in the market, [the SFC] may impose a heavier penalty than in the past."

We welcome the endorsement by the SFAT chairman of our approach in imposing heavier penalties on prevalent misconduct where no compensation is offered.

The SFC reiterates that firms that enter into fair and reasonable agreements to compensate affected clients for losses caused by

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their misconduct will obtain significant and material recognition of that fact in our assessment of whether formal enforcement action is needed and/or the type of enforcement action that may be taken.

Please follow this link to access the [SFAT determination](#).

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## Corporate Governance under Scrutiny

The SFC has announced the start of three separate proceedings in the High Court seeking orders against nine current and former company directors for alleged misconduct.

These proceedings are brought under section 214 of the Securities and Futures Ordinance (SFO) which gives the court power to make a range of orders including:

- disqualifying a person from being a company director or from being directly or indirectly involved in the management of any corporation for up to 15 years;
- ordering a company to bring proceedings in its own name against any person specified in the order; and
- making any other order that may be appropriate.

In each of the three cases, we shall argue that the directors were wholly or partly responsible for the companies' affairs being conducted in a manner involving defalcation, fraud or other misconduct.

Company directors have an important fiduciary obligation to ensure shareholders' funds are used in the best interests of the company and not used for personal reasons or recklessly. In each of these cases, the SFC's position is that this primary duty to the company was breached and that, in some of the cases, the directors did not ensure shareholders received information they reasonably expected.

In two cases, the SFC will ask the court to make orders that the responsible directors pay compensation to the company for the losses caused by their breaches of duty. This is the first time we will be asking a court to make orders of this kind. In doing so, we are not seeking to make directors personally responsible for financial losses that are incurred in good faith. Rather, we are focusing on cases where alleged misconduct and bad faith by directors has led to the loss of shareholders' funds.

We are committed to using all available tools at our disposal to achieve the objective of reducing crime and misconduct in our markets. The use of section 214 of the SFO is an example of this commitment.

For further details, please follow these links to our press releases dated [3 September 2008](#), [9 September 2008](#) and [25 September 2008](#).

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## Insider Dealing

In the last two editions of the Enforcement Reporter, we explained our work on insider dealing. We have made further progress on this front recently.

### Further Criminal Prosecutions for Insider Dealing Undertaken

The SFC has started its fourth and fifth criminal prosecutions for insider dealing.

Proceedings were brought against Mr Allen Lam Kar Fai, a former investment banking director at CLSA Equity Capital Markets Ltd, and Mr Ryan Fong Yen Hwung, a former fund manager at HSZ (Hong Kong) Ltd.

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CLSA acted as the financial adviser for a purchaser of Media Partners International Holdings Inc. The SFC alleged that Lam, while employed by CLSA, knew about the acquisition before it was announced and disclosed it to Fong.

At the time, Fong was a director of HSZ. He purchased a total of 10,626,000 shares of Media Partners for an HSZ fund and for himself at prices ranging from \$0.6 to \$0.83 from 21 July 2005 to 12 September 2005. After the acquisition was announced on 21 September 2005, Media Partners' share price rose and Fong was able to sell the shares at prices ranging from \$1.09 to \$1.10.

Lam and Fong appeared at the Eastern Magistracy on a total of three insider dealing charges on 25 September 2008 and no plea was taken. On 16 October 2008, the Eastern Magistracy granted an application by the Department of Justice to transfer the case to the District Court. Lam and Fong will appear for plea in the District Court on 4 November 2008.

In the fifth criminal prosecution for insider dealing, proceedings were brought against Mr Andy Lam King Hung, an accounting manager of Chinese Estates Holdings Ltd, and his wife Ms Fung Lai Sha.

The SFC alleged that Lam placed orders through the accounts held in his name and his wife's to buy shares of Chi Cheung Investment Co, Ltd in August 2007 before a proposed asset swap transaction between Chi Cheung and Chinese Estates was announced to the market. Following the announcement of the proposed transaction on 8 August 2007, the share price of Chi Cheung rose by approximately 30%.

The couple pleaded not guilty in response to six summonses on 23 October 2008. The case was adjourned to 4 December 2008 for pre-trial hearing and will proceed as a summary prosecution in the Magistrate Court.

For further information, please follow these links to our press releases dated [25 September 2008](#) and [23 October 2008](#).

### **Former Investment Banker's Insider Dealing Case Transferred to District Court**

The third prosecution commenced by the SFC for insider dealing, involving Mr Du Jun, a former managing director at Morgan Stanley Asia Limited, was transferred to the District Court after an application by the Department of Justice. Du will appear for plea in the District Court on 25 November 2008.

For further information, please follow these links to our press releases dated [17 July 2008](#) and [5 September 2008](#).

### **Market Misconduct Tribunal Finds Three Persons Culpable of Insider Dealing**

The Market Misconduct Tribunal (MMT) recently submitted reports to the Financial Secretary in relation to dealing in the shares of Sunny Global Holdings Limited. The MMT determined that three persons were culpable of insider dealing. In relation to this, the MMT ordered, among other things, that the profit gained of approximately \$600,000 be paid to the Government, and that two of the three persons shall not be a director, liquidator, receiver or manager of the property or business of a listed company for a period of 12 months.

For further information, please follow these links to the MMT's press release dated [8 September 2008](#), reports dated [21 July 2008](#) and [29 August 2008](#).

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## **Court Appoints Administrators over Unlicensed Futures Dealer**

The High Court recently granted an SFC application appointing administrators over Gartlett Investments Ltd, which was suspected of conducting unlicensed futures dealing in Hong Kong on behalf of approximately 200 clients. The court also ordered the firm to stop its dealing business.

An SFC investigation revealed that mainly commodity futures contracts were traded through London brokers on the London Metals Exchange. In a sample of over 2,400 contracts executed in the last two weeks of August 2008, the SFC found that a total value of over US\$950 million was involved and most clients appear to be mainland Chinese.

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Given the scale of the unlicensed activity and that client and company money appears to have been mixed, the SFC decided that it was necessary to appoint administrators to take possession of the company's records and bank accounts, identify and segregate client money, oversee an orderly closure of outstanding client positions and report to the court.

The SFC is prepared to exercise its full range of powers under the SFO to stamp out unlicensed dealing.

For further information, please follow these links to our press releases dated [12 September 2008](#) and [19 September 2008](#).

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## Court Dismisses Challenge to Market Misconduct Tribunal

On 22 September 2008, the Honourable Mr Justice Hartmann of the High Court dismissed applications for judicial review in relation to Market Misconduct Tribunal (MMT) proceedings. The issues in the application were as follows:

- whether the proceedings were criminal or civil in nature,
- whether the notice issued by the Financial Secretary in the proceedings had complied with the requirements of the SFO, and
- whether the MMT had the power to compel an applicant to give testimony and to admit into evidence her record of interview obtained under compulsion by investigators.

On the first issue, the court held that the proceedings before the MMT are civil, though they are not to be equated in all respects with private civil law proceedings. The proceedings have their own special character because they are regulatory in nature. Further, the court said that the "primary purpose of the statutory powers of sanction given to the Tribunal are not penal but protective."

As to the second issue, the court held that section 253(1)(b) of the SFO does compel all persons specified by the Financial Secretary to give evidence if the MMT so requires. The possibility of self-incrimination provides no grounds for refusing to testify. However, the court went on to say that "what must be underscored... is that, although evidence is compellable, even by a person believed by the Financial Secretary to have committed acts of market misconduct, such evidence is, with very limited exceptions, only admissible in those proceedings before the Tribunal."

Further, as the proceedings are civil in nature, the person summoned has no right to silence.

The High Court judgment provides helpful clarification about the status of proceedings and evidence before the MMT.

For further details, please follow this link to the judgment handed down by the High Court on [22 September 2008](#).

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## Enforcement Policies and Practices

### SFC's Surveillance Preserves Market Orderliness

One of the SFC's regulatory objectives under the SFO is to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry.

This objective can be achieved in a number of ways. Active daily market surveillance is one way to encourage compliance and reduce the risk of crime or misconduct harmful to the market.

Our Surveillance Department in the Enforcement Division monitors the activities of Hong Kong's securities and futures markets and conducts inquiries into trading irregularities. Where the Surveillance Department notes unusual or suspicious trading activity, it may issue a notice under section 181 of the SFO requiring information about the transactions concerned. Our surveillance function generates a significant portion of our market investigation work that leads to the prosecution of illegal manipulation and insider

dealing cases before Hong Kong's courts and tribunals.

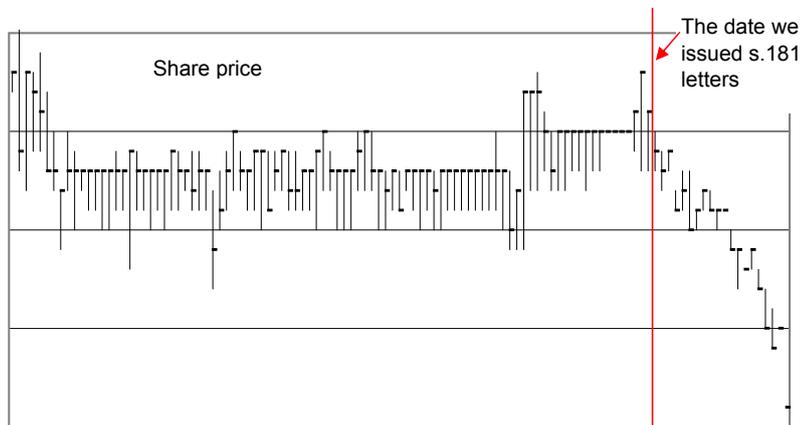
The SFC's recent experience shows that the issue of section 181 notices can and did result in a cessation of suspicious trading in the shares of a listed company, thus contributing to the orderliness of the market.

This can be demonstrated by the two graphs set out below. Graph 1 shows the share price of a listed stock in Hong Kong over a period of four months. Graph 2 shows the trading volume of the stock over the same period.

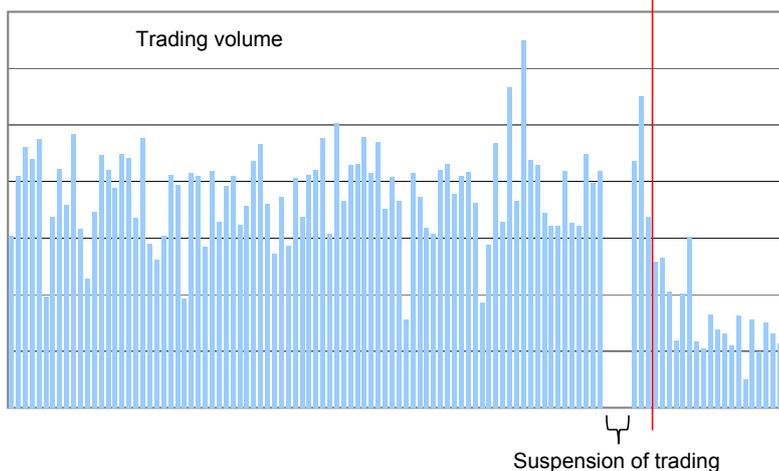
Both the share price and trading volume were higher before the suspension. Graph 2 reveals that the trading volume reached its high point shortly before trading was suspended. The red line marks the point when the SFC served the section 181 notices. Immediately after the notices were served, both the share price and the trading activity fell sharply.

The section 181 notices appear to have alerted the brokers or their clients to the SFC's interest in certain trades and to the possibility that the SFC will inquire into possible manipulative activity, helping to bring a halt to suspicious activities.

**Graph 1: Share price of a Hong Kong-listed stock over a four-month period**



**Graph 2: Trading volume of the stock over the same period**



## Compliance Advice Letters Address Algorithmic Trading Concerns

In past editions of the Enforcement Reporter, we have explained the introduction and function of compliance advice letters in place of warning letters formerly issued. These letters have addressed a variety of topics including cold calling, disclosure of interests and internal control weaknesses.

One subject of recent compliance advice letters is the use of algorithmic trading systems. As trading systems that automatically execute trades on the basis of a program with certain preset parameters, these are becoming increasingly popular and are having a bigger effect on markets.

We acknowledge that algorithmic trading systems play a legitimate role in executing trades, freeing dealers to concentrate on more judgment-intensive work. However, the lack of human supervision of algorithmic trading systems can pose compliance problems.

In one instance, where an algorithmic trading system was left to run as if on auto pilot, it aggressively sold a low-liquidity stock in a limited time with no time limit parameter for the execution of the trades. As a result, the share price was pushed down dramatically. This was not in the interests of the client, and was inconsistent with the trader's obligations under the Code of Conduct to act in the best interests of market integrity.

We would like to remind licensed companies to put in place suitable policies and procedures governing the use of all algorithmic trading systems. Licensees must:

- understand the manner in which their systems execute trades;
- set proper parameters for trade execution so that the trading systems will not distort the market or affect market integrity;
- ensure staff are sufficiently trained in the setting of proper parameters and operations and supervision of the systems; and
- use these systems appropriately.

We also recommend that licensees monitor algorithmic trading periodically, both during and after trading hours.

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## Disclosure of Interests

The SFC continues to attach importance to the obligation of directors and substantial shareholders to make timely disclosure of their interests in listed companies.

Under Part XV of the SFO, listed company directors, chief executives and substantial shareholders are required to disclose and notify their company and the Stock Exchange of Hong Kong of changes in their interests.

From 1 August to 30 September 2008, the SFC prosecuted four entities for breaches in disclosure of interests. In all these cases, the defendants pleaded guilty. Fines ranging from \$4,000 to \$10,000 were imposed.

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The Enforcement Reporter is available under 'Speeches, Publications & Consultations' – 'Publications' of the SFC website at <http://www.sfc.hk>.

Feedback and comments are welcome and can be sent to [enfreporter@sfc.hk](mailto:enfreporter@sfc.hk). We will consider the comments and, where called for, provide a response.

If you want to receive the Enforcement Reporter by email, simply register for the Update Email Alert service at <http://www.sfc.hk> and select Enforcement Reporter. Intermediaries licensed by the SFC receive the Enforcement Reporter via their FinNet email accounts.

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