

Speech at Foreign Correspondents' Club, Hong Kong

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Good afternoon – and thank you very much for inviting me to speak at the Foreign Correspondents' Club (FCC). In a rather odd article in the SCMP just yesterday, the writer was talking about our IPO sponsors consultation and said that “Alder should continue what my predecessor Martin Wheatley started. A good measure of his success will be how unpopular he can make himself at the Hong Kong Club”. Well, I would just like to say that social exclusion anywhere is not a personal goal and for that reason a warm welcome at the FCC would be hugely appreciated!

Turning to business, we have recently had a fair amount of media coverage of our proposals for IPO sponsors – including some eye-catching headlines with combinations of words that seem to have become popular worldwide – “bankers” and “jail” being the most common pairing. I expect that some of you would like me to speak more about this, which I will later on.

But first I want to come back to Hong Kong and speak about enforcement, which I know is a subject of interest to many.

SFC's enforcement approach

Many have characterised the Securities and Futures Commission (SFC) as an organisation which is an investigator, a prosecutor, jury and judge all rolled into one. In an article about the well-known Tiger Asia case it was said that we cannot “*take any pride in our legal system when it allows government agencies to penalise people for offences before proving these offences*”. If true that result would be appalling. But of course it isn't true.

The same article noted that the Court of Appeal had said that “*in the present [Tiger Asia] case the alleged contraveners are outside the jurisdiction and criminal prosecution may be difficult or impossible*”. The writer said that he would like to see the “*SFC parrot these words when saying it protects investors in a market when most of the listings are China based firms*”. I am afraid that it is obvious that no regulator's reach is the same overseas as it is at home. In fact, Mark Steward, SFC's head of enforcement, pointed out in yesterday's Financial Times that Hong Kong's attraction for companies and investors located elsewhere “*gives rise to a significant enforcement and jurisdictional challenge*” and that “*this is a problem most other jurisdictions do not have to the same degree*”. This is why our co-operative arrangements with overseas regulators are more vital for us than virtually any other place.



In fact the SFC's approach to enforcement and market misconduct has been pretty consistent in recent years. We use – and are obliged to use – the full range of remedies and sanctions available to us to tackle wrongdoing that affects market confidence and integrity.

This means we will pursue both criminal and civil remedies either separately or in tandem. We must give priority to deterrent sanctions – especially criminal sanctions – but we will also address the consequences of misconduct through remedial orders whenever we are able to do so. Remedial orders are basically about putting an end to continuing misconduct and providing redress to investors.

Insider dealing and market manipulation have been characterised in legislation as criminal offences, and as such they represent conduct which is not merely a breach of regulation, but conduct that the community deems falls far short of acceptable standards.

As a result, there is a legitimate public expectation that serious market crimes and other misconduct are tackled energetically and effectively. There is no doubt that securities regulators who are not active in enforcing the laws under their wing are falling down on their job and ultimately serve to encourage illegal behaviour, thereby harming investors and the overall quality of the market.

However, the forensic challenges in establishing criminal market misconduct are formidable. Hong Kong has therefore established a Market Misconduct Tribunal (MMT) as an alternative to prosecution. The MMT is an independent tribunal chaired by a High Court judge which is able to impose deterrent or deterrent-like orders on offenders on the basis of the civil standard of proof. The test is a balance of probabilities rather than the “beyond reasonable doubt” test in criminal cases. MMT sanctions include disgorgement of profits, excluding offenders for participating in the markets and directors' disqualifications.

For many years, proceedings in the MMT and its predecessor – the Insider Dealing Tribunal – were commenced by the Financial Secretary and prosecuted by the Department of Justice following referral by the SFC. The Government and Legco have recently decided that the SFC can bring cases directly to the MMT without first referring the case to the Financial Secretary. This is an important development. While the SFC has always been able to bring criminal proceedings in relation to market misconduct, MMT cases can now be pursued by the SFC in the same way. This should among other things lead to a faster and more efficient process.

Importantly, there is a statutory double jeopardy rule which protects anyone from being subject to both criminal and MMT proceedings in relation to the same matter. This reinforces the function of MMT proceedings as a penal and deterrent alternative to criminal proceedings when criminal proceedings cannot be brought.

There are however two other ways in which the SFC is able to tackle market misconduct, which were included in the law as additions to the MMT and criminal courts to serve different purposes.

The first is to enable the SFC to seek “remedial” orders to cure the consequences of wrongdoing through proceedings under section 213 of the Securities and Futures Ordinance (SFO). This is the Tiger Asia case. The second is our disciplinary process for brokers and other licensed intermediaries. I will talk more about this in a moment.



But first, I know that you love – or sometimes love to hate – statistics.

Tackling market misconduct

Since 2007, there have been 32 charges of insider dealing which have led to convictions against 12 defendants and over 170 market manipulation convictions. This means that in the past five years the SFC has secured more than two-thirds of the total number of market misconduct convictions recorded since 1989, when the SFC was set up.

These cases include the conviction of former investment banker Du Jun who was jailed for seven years. He has recently appealed his conviction and sentence and we are awaiting a decision by the Court of Appeal in his case.

A further eight people have been found to have engaged in insider dealing by the MMT.

So in total, 20 people have been found to have contravened Hong Kong's insider dealing laws either through the criminal process or by the MMT.

In each of these cases, the decision has been made by an independent court or tribunal based on the presentation of evidence which can be contested by the defendant. In fact, the MMT operates a full inquisitorial approach – including the ability to call for new evidence and to widen the scope of its enquiries.

Further cases are currently pending in the criminal courts and the MMT, including the adjourned criminal trial of a former senior executive at CITIC Pacific, who is charged with insider dealing in relation to allegations that he sold his CITIC Pacific shares ahead of the announcement of the company's foreign exchange losses in 2008.

Yesterday the MMT was hearing submissions in relation to potential orders that it might make against a US-based fund manager with Fidelity, who has been found by the MMT to have contravened Hong Kong's insider dealing laws, and another MMT hearing is starting today. You may have seen today's news that a case is now before the MMT involving alleged insider dealing in shares in China Huiyuan Juice before a bid by Coca Cola was made public.

So all in all we are pretty active.

Section 213

I would now like to explain the SFC's use of section 213, which has attracted a lot of attention as a result of the Tiger Asia case and seems on the face of it to have taken some in the legal profession by surprise.

I am surprised that they were surprised. I have to say that when I was in private practice most lawyers I knew who were familiar with this area did not believe that it was at all unusual.

This is because the whole purpose of section 213 is to provide an additional way of addressing the consequences of insider dealing and market manipulation. This was expressly set out in the Government's Consultation Paper for the new SFO in 2000, and the proposal drew no surprise or reaction from the financial industry or the legal profession at the time.



In the on-going Tiger Asia case, the Court of Appeal recently held unanimously that the Court had full jurisdiction to make final orders under section 213 describing the provision as, “..... *much needed ammunition to the Commission to protect investors.....*”.

The Court of Final Appeal has granted leave to the Tiger Asia parties to appeal but in the meantime the Court of Appeal’s decision states the current position under Hong Kong law.

Section 213 is an important adjunct to our ability to protect investors. These are few of the things the court can do:

- first, transactions which contravene the law can be reversed so that people who have been innocently harmed might be restored to the same position they were in before the misconduct occurred;
- second, injunctions restraining continuing misconduct can be ordered;
- third, money that might be used to pay fines or meet claims for loss or damage can be frozen; and
- fourth, compensation for loss or damage from those who contravene the law can be awarded to victims.

The SFC is not overreaching in invoking these powers. These are the orders that section 213 says the SFC is able to seek from the Civil Court, and that the Court must first decide that the law has been contravened on evidence and after a full hearing, as occurs in all other courts and tribunals. The Court does not proceed on the SFC’s “say so” and it is extraordinary to think that it might. The other important point is that section 213 – as distinct from the MMT or the criminal courts – has a unique function in providing remedies for investors and that is why it does not exclude criminal or MMT proceedings for the same conduct, which are punitive in nature.

The Hontex case

An example of what might be achieved for investor protection under section 213 is shortly to be looked at by the courts with the long awaited trial in the Hontex case scheduled to start in two weeks.

In April 2010, we took action under section 213 to prevent the dissipation of almost \$1 billion raised by Hontex in its IPO. We alleged false and misleading statements in the prospectus and sought freezing orders to allow the eventual return of money to affected investors.

The case is a challenging one because nearly all key elements are outside Hong Kong. First, the company is incorporated in the Cayman Islands with no presence in Hong Kong, and any return of subscribed capital to investors must involve a reduction of capital that complies with Cayman Island law. Second, the directors all live outside Hong Kong. Third, the company’s business was wholly outside Hong Kong which means all the evidence must be sourced from outside Hong Kong.

On the other hand, most of the investors were retail investors in Hong Kong and the company’s responsibilities to ensure its prospectus was correct are ones that exist under Hong Kong law. The case is a significant test not only of whether section 213 is able to



operate as intended – but also of whether the existing provisions in the law which deal with false or misleading statements in our market actually work properly.

The SFC is currently taking action against 22 defendants in ongoing section 213 proceedings in which insider dealing allegations have been made. All of these cases are an expression of our focus on mitigating investor losses through remedial measures ordered by the court.

SFC's powers

Coming back to those who believe that the SFC has unbounded powers to do what it likes in enforcement cases, the fact is that in every action, the SFC is required to prove its case before independent judges where the SFC bears the burden and the evidence is scrutinized by all those affected. And the same goes for the MMT.

It is also important to understand that in disciplinary proceedings under our licensing system for brokers, asset managers and the like, our decision is not operative or final unless and until those involved have had the chance to seek a review by the Securities and Futures Appeals Tribunal. This is another decision maker which is entirely independent of the SFC. The tribunal is able to conduct a full merit review of cases and is part of a single disciplinary process. For this reason no announcement is made until either there is no appeal or until an appeal is decided.

The bottom line is that we regard hard, rigorous testing of our cases in the public eye by independent courts and tribunals to be of fundamental importance to the integrity of the regulatory framework in Hong Kong. This scrutiny is vital to ensure that all involved are treated fairly, including the regulator, the regulated, and the investing public.

Regulation of sponsors

I would now like to move onto IPO sponsors.

We published a Consultation Paper on this subject about two weeks ago. Given the extensive press coverage, I am sure many of you are familiar with the proposals and therefore I am not going to go through them in great detail now.

Our proposals

Even before we published the Consultation Paper, the headlines were already focused on whether we would see bankers exchanging their suits for the less attractive clothing issued by the Correctional Services Department.

Understandably, criminal liability attracts headlines. As one journalist told me, this is the interesting bit to focus on to get a story on or near the front page, and that is perfectly understandable. You don't really want to write about the boring bits. However, and as you might expect, the vast majority of the paper is not about legal liability. It concerns instead the standards of investment banking work under our Code of Conduct which is just as important as those parts dealing with liability.

So I hate to disappoint you: we are not on a mission to put bankers in jail.

What we want to do instead is to improve the quality of due diligence done by sponsor firms – basically that they apply a rigorous “know your client” approach to companies aspiring to do an IPO. Our objective is to change behaviour to provide greater assurance that



prospectuses provide quality information that allows investors to make informed decisions. If we succeed in this aim we will also succeed in another goal: that we will not have to resort to enforcement action.

Many have asked why this focus on IPO sponsors. The simple answer is that confidence in the information given to the market in an IPO flows from confidence in those who have a pivotal role in selecting companies to list, marketing shares directly to institutional investors and in ensuring the accuracy, completeness and relevance of the information disclosed to the public. The sponsors have this pivotal role. But that is not to say that others are not important. Advisors such as lawyers and accountants are crucial and, above all, the directors know most about a company. However, we expect the sponsors to test the information they are given by the directors and senior management and in many cases to collate information from other sources to establish a complete picture.

The proposals were strongly influenced by the deficiencies we have seen in some sponsor work over the past few years. Let me stress that some of this work has been performed to high standards, but unfortunately there is no consistency – even within one bank. In essence, our concerns relate to sponsors not devoting enough resources to an IPO and, as a result, overtrading. This includes not assigning the right individuals to a deal at the right time and a lack of senior management involvement to ensure proper deal planning and execution. In brief there are three key proposals relating to sponsor work:

1. First, they should complete the majority of their due diligence on the company before submitting an advanced draft prospectus to the Stock Exchange. Sponsors should kick the tires hard – all four of them – before submitting an application for listing approval. This ensures that issues are identified and addressed and the draft prospectus is sufficiently complete to allow the formal listing process to be far more reliable and efficient. We also propose that the draft of the prospectus submitted with the listing application is published on the Stock Exchange website. This public exposure is designed to enhance the quality of the work done to produce this draft.
2. Second, sponsors are responsible for due diligence whether they carry it out directly or seek assistance from others. They should review the results of the due diligence carried out by others and ensure that the results are reflected in disclosure in the prospectus or in additional work.
3. Third, sponsors cannot just place blind reliance on experts such as accountants and valuers whose reports are included in the prospectus. For example the sponsor needs to review the draft financial statements produced by the auditors, and assess whether they are consistent with all the other information the sponsor knows about the listing applicant. This does not mean that sponsors should repeat work done by auditors on the underlying accounting records, or “audit the auditors”. That would be absurd. But it does mean having a good look at the financial statements resulting from the audit work and ensuring that they are consistent with the sponsors own detailed understanding of the company’s business model and market.

Legal liability

Now, the part which gets a lot of people excited: legal liability.

There are in fact differing views as to whether sponsors are already subject to civil and criminal liability under the Companies Ordinance. Many lawyers are of the view that they are



already covered – but unfortunately this is not explicit. What we are now consulting on is whether or not it should be made clear in the Companies Ordinance that sponsor firms – that is firms as distinct from individuals – should be subject to civil and criminal liability for untrue statements in prospectuses. Lack of clarity is not the right outcome for anyone involved.

I should also say that it is absolutely clear that a criminal prosecution should only be pursued in serious cases reflecting a community expectation about conduct meriting criminal punishment. And as a starting point there must be an untrue statement in the prospectus about something significant. This is not to do with the standard of a sponsor's work falling short where there is no major problem with the prospectus. This would potentially be a licensing issue but has nothing to do with legal liability. As the law now stands, liability is about a lack of belief that an important representation in a prospectus is in fact true.

I should also say that coverage of the criminal topic has obscured the need for clarity about civil liability, which would provide investors with the potential to seek redress directly. Although our civil litigation system can be off putting – in part because of expense – we think that clarity about the availability of both civil remedies and criminal liability will have a further positive influence on behaviour amongst sponsor firms.

As I said, the proposals about liability are about sponsor firms. We are not proposing to identify individuals. I would say, however, that if individuals actively assist in the inclusion by anyone of untrue statements in a prospectus, and if it's a serious case, they could be justifiably subject to criminal liability under the general law.

I hope this clarifies some of the issues now being debated about our proposals. We have studied different approaches in other jurisdictions and we are very focused on the right solution for Hong Kong, recognising that our market is in a large part about companies from other jurisdictions raising funds through our exchange from overseas and local investors. The Hontex case illustrates what can happen when things go wrong, and the points I made earlier about effective enforcement outside Hong Kong means that it is vital to ensure so far as possible that companies list here on the basis of reliable information.

Finally, we have seen remarks that companies would try to list on other markets as a result of these proposals. My view is that this is not a real risk and that if some who can't match up to reasonable expectations of competence and integrity go elsewhere that is no bad thing. A market succeeds when it attracts both investors and issuers. Investors rely on information in prospectuses and confidence in that information is essential for a thriving market for new listings. Investors we have talked to, both big and small, have rammed this point home loud and clear. They tell us that confidence in information is directly correlated with their willingness to invest and the price they pay. This should produce a virtuous circle – more confidence attracts more investors and quality companies will take their disclosure obligations seriously as the best way to connect with their future shareholders.

At the heart of it all, the proposals are about how to assist the market to improve the quality of our IPOs. If we succeed in that goal, it can be measured by how infrequently we resort to enforcement action or criminal prosecution. Our aim is not to prosecute but rather to encourage behaviour which should make our enforcement division less busy.

Our consultation period is two months and the consultation process is a genuine one. There are bound to be different views and I would encourage the industry to approach us if they wish to discuss them directly.



In closing, I should just say on a personal note that I was aware when joining the SFC that being a regulator is not a popularity game: you have to get used to well informed and not so well informed commentary, and that goes with the territory worldwide. However, I would just like to make clear that all commentary is informative and some is extremely helpful, so I would encourage all of you here at the FCC who work in the media to remain engaged in financial and regulatory issues which more than ever have a profound effect on the real economy.