

## Compliance and Corruption Across Asia Compliance Summit Asia

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The realm of enforcement, as this morning's agenda wryly puts it, is a subject well worth a few moments of reflection.

Our core enforcement mission is to vindicate obligations that are not met, especially those owed to, and harming the interests of, the investing public. It can be described in more technical ways but essentially this is it.

I would like to talk about how we go about this mission in light of a trio of decisions handed down by the High Court this year in our cases.

But first I would like to make a few observations about misconduct in our markets.

### **Increasing Misconduct?**

The incidence of misconduct in our markets appears to be increasing rather than decreasing. More seasoned observers might think nothing much has changed over the decades. Perhaps there is more detection and more is being done about it nowadays.

I am not aware of any reliable study and perhaps such a study is impossible given the unknown variable of undetected misconduct.

But, subjectively, there may be some basis to believe misconduct has increased despite the considerable contrary efforts of many people around the world.

Since 2007 there has been an increase in the number of investigations we have commenced and completed in our key areas of interest.

*Since 2007:*

- insider dealing investigations have increased by more than 250%;
- market manipulation investigations have increased by 240%;
- corporate governance cases have increased by 530%; and
- intermediary misconduct cases have climbed by 280%.

The consequence of so many cases is that there has also been an increase in the number of cases before Hong Kong's courts and tribunals as well as a change in the nature, complexity and seriousness of these cases.



The most significant increase is in the amount of civil litigation, especially before the High Court where, again comparing with the position five years ago, there has been an increase in activity of over 450%.

*Using insider dealing cases as a benchmark or yardstick, in the same period we have taken actions against 44 people for insider dealing:*

- leading to 33 criminal convictions against 13 defendants;
- the Market Misconduct Tribunal has made findings that a further eight persons have contravened the insider dealing prohibition with administrative orders being made against them; and
- we have commenced civil proceedings against a further 22 defendants alleging insider dealing in cases pending before the High Court.

Much of this misconduct is committed so easily too. The insider dealer or manipulator makes a phone call or pushes some buttons on a computer. No need to see the victim at the end of the process. The consequences are not visible: physically insulated from the victim perhaps leading to emotional and moral insulation from the consequences of misconduct as well.

Intuitively, it seems a person is more likely to act improperly where there is a high degree of attenuation between the act of misconduct and its consequences.

The consequences of misconduct may be a topic that deserves more attention from regulators.

### **Consequences of Misconduct**

Would, for example, a financial institution pay more attention to its anti-money laundering processes if brought face to face with the associated harm caused by drug trafficking or corruption that its laxness is facilitating?

Would the listed company consider the almost certain losses that would be incurred by the golden age investor buying shares with his pension pot when deciding to delay the disclosure of the bad news to the market?

There remain many who believe, for example, that insider dealing is victimless because counterparties to insider dealing would have traded anyway.

The disobligation underlying this argument insulates the wrongdoer from having to acknowledge the obvious consequences of his misconduct.

The insider knows the current trading price is not accurate because highly relevant news has not been factored into it. Often the insider is also able to influence the timing of the announcement or is privy to the timetable of the announcement. The unfairness of his advantage is not limited to the price sensitive information. In these circumstances, it is difficult not to see the innocent counterparty is anything other than a victim of a deliberately orchestrated unfairness.

Underlying the disobligation of consequences is the dubious assumption that the innocent trader is no different or worse off by trading in a market that included a prohibited insider trading in the opposite direction. In most cases, the innocent trader will be worse off. In some cases, the innocent trader may well have continued to trade – for example, selling



shares to raise urgently needed cash – but in those cases, the question is not so much whether the trader would have traded anyway but whether he would have traded at the same price if he knew what was going on.

A wrongdoer who cannot or does not see the consequences of his misconduct is less likely to perceive their moral and social consequences and more likely to offend again.

In many of these cases, there is a sense that perpetrators have convinced themselves that not only is the risk worth running (because the forensic challenge of detection is in their favour) but that the consequences are not serious. This creates a moral and ethical vacuum.

For some time now we have been working on ways to make wrongdoers accountable for the consequences of their misconduct. The process sounds simple but it is not.

In the course of this year, there have been three important developments in this long term project, a trio of decisions handed down by the Court of First Instance of the High Court of Hong Kong.

### **Tiger Asia<sup>1</sup>**

The first decision was the Court of Appeal's in the Tiger Asia case which overturned the first instance ruling to the effect that the High Court does not have jurisdiction to determine whether a market misconduct contravention had occurred for the purposes of making remedial and compensatory orders to victims.

The legal proceedings against Tiger Asia are brought under section 213 of the Securities & Futures Ordinance (SFO), a little used provision which we have made a significant part of our strategy.

Section 213 permits the Court of First Instance to grant remedial orders in response to contraventions of the SFO. The provision effectively gives the court power to reverse transactions that have been effected through contraventions by ordering parties to take steps to undo what has been done and/or potentially pay damages. The combination of injunctions and recessionary orders to reverse consequences of misconduct may well constitute a powerful antidote to the problem of ensuring the real consequences of misconduct are brought home to wrongdoers.

Tiger Asia, a New York-based hedge fund, against whom we allege insider dealing and manipulation in the shares of Bank of China and China Construction Bank (no finding has been made in these proceedings to date), argued that the Court has no jurisdiction to make findings of contravention without a pre-existing finding by a criminal court or the Market Misconduct Tribunal. This argument succeeded at first instance. But earlier this year the Court of Appeal unanimously overturned the initial decision and held that the Court clearly had jurisdiction to make findings of contravention on its own.

The Court of Appeal's decision is destined for the Court of Final Appeal next year where the position will be sorted out once and for all.

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<sup>1</sup> Securities and Futures Commission v Tiger Asia Management LLC & Ors [2012] HKCA 85 (23 February 2012)



We are confident that our position will be vindicated and that section 213 proceedings will form a key part of our strategy in bringing wrongdoers face to face with the real consequences of their misconduct.

Not only do we believe that the provision was intended and designed to operate in a self-standing way (and the legislative materials support this view), it makes little or no sense for an essentially remedial proceeding to be ancillary to any other type of action. Certainly there does not appear to be any public purpose or rationale to support this view and to inhibit the purpose of proceedings under this provision.

As matters stand at present, the Court of Appeal's decision handed down in February this year is the law in Hong Kong and we are able to proceed with these types of cases on the basis they are self-standing.

### **Styland<sup>2</sup>**

The second key decision in this trio of important cases is the Court of First Instance's decision in our case against several directors of Styland. Styland is a listed company in Hong Kong. Our case concerned the conduct of the chairman of the company and a number of directors who caused the company to enter into a number of transactions which had the effect of conferring benefits on themselves or related parties and consequential losses.

The mischief here was that the transactions appeared to be at arm's length with unrelated parties.

Judgement was handed down in March this year with findings in favour of the SFC's allegations.

This is an important decision because it is the first time, in proceedings brought by the SFC, that directors of a listed company have been found guilty of misconduct for causing direct loss to the company, and the Court has ordered compensation to be paid.

The amount of compensation was approximately \$85 million together with interest and the total amount payable will be in the order of several hundred million dollars.

This decision has paved the way for further cases of this kind to be brought ensuring that company directors can be made accountable for breaches of duty that cause loss of shareholders' funds.

And a second case against another listed company director was concluded in September with a second compensation order made in favour of China Asean resources, formerly Medical China, again involving payments that appeared to be to unrelated parties and for legitimate purposes but instead were paid to various persons related to the defendant.

This brings me to the third keystone decision in the High Court this year, the Hontex case.

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<sup>2</sup> Securities and Futures Commission v Kenneth Cheung Chi Shing & Ors [2012] HKCFI 312 (7 March 2012)



### **Hontex<sup>3</sup>**

The Hontex case fulfils the promise of the High Court's jurisdiction under section 213 that we are fighting so hard to preserve in the Tiger Asia litigation.

The story is now well-known. Hontex was incorporated in the Cayman Islands and operated a business in the Mainland. It was listed on the Stock Exchange of Hong Kong in December 2009. In March 2010, we discovered that important elements of the IPO prospectus grossly misstated the company's financial position, in particular, its turnover, cash and the number of its franchise stores in the Mainland during the track record period prior to listing were grossly overstated.

We immediately exercised our powers to suspend dealing in the company's shares and sought urgent injunctions, in our section 213 proceedings, to restrain movement of the company's assets. As it turned out, out of the \$1 billion raised in the prospectus, approximately \$832 million remained in bank accounts in Hong Kong. This amount was frozen.

We then set about seeking orders to reverse the IPO subscriptions for those shareholders who wanted their money back.

The case went to trial in June this year. After more than two weeks of evidence, the company conceded that it was reckless in allowing materially false information to be included in the IPO prospectus. The controlling shareholders agreed to top up the amount that had been frozen with a further sum of \$197 million which was paid into court and, when added to the \$832 million already frozen, the total created a fund out of which the company could effectively reverse the subscriptions by making a buyback offer.

The buyback process required compliance with Cayman Islands law and so required the approval of the public shareholders in general meeting.

In effect, the company and its controlling shareholders (who were ordered to vote in favour of the buyback) were brought into the same room, face to face with the victims who had invested their money at the shareholders' meeting. The buyback was approved and the public shareholders have almost unanimously accepted the offer (at least 99% of them).

Cheques totalling approximately \$1 billion, a total comprising almost all the publicly raised capital of the company, have been issued to more than 7,000 investors.

This outcome repairs the immediate damage caused to those shareholders who were in no position to detect the false information in the prospectus and who were victims of this serious contravention by the company.

And the market, as a whole, benefits from knowing there is now a mechanism to undo the consequences of false or misleading prospectuses.

We have a string of other cases like this one pending before the Court (not involving IPO prospectuses but other kinds of alleged misconduct), many with substantial sums of money frozen as a result of interim injunctions made in section 213 proceedings.

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<sup>3</sup> Securities and Futures Commission v Hontex International Holdings Co Ltd & Ors (HCMP 630/2010, unreported, 20 June 2012)



I want to mention one codicil to the Hontex case. The requirement that the buyback be approved by the shareholders in general meeting was a happenstance in which the company effectively came face to face with the victims of the wrongdoing. In other contexts, these kinds of meetings have been mandated with good effect.

For example, the Minibond resolution in 2009 required the participating banks to engage in an enhanced process to resolve issues concerning the sale of other types of structured products sold to retail customers. This process included face to face discussions between the banks and their customers. The point of these meetings was twofold: first to resolve the issues of concern and secondly to re-establish the relationship between the institution and the customer.

This process has avoided mis-selling resolutions by or through agents that kept affected parties at arm's length. Under this process, some but not all customers have received compensation and approximately \$1 billion has been paid out. The process appears to have been remarkably quiet and effective in resolving concerns, one way or the other, and re-establishing effective relationships.

### **Conclusion**

None of this is at the expense of deterrence and in the last month we have had guilty verdicts delivered in separate manipulation and insider dealing cases. We will continue to seek deterrent sanctions where they are appropriate.

But deterrence alone is not a sufficient remedy if the consequences of the wrongdoing remain unaddressed and making wrongdoers account properly for the consequences of misconduct must itself have salutary consequences for the wrongdoer and our markets.

On that note, I wish you a fruitful experience at today's Summit.