Fighting On the Frontline: An Update
3rd Annual US-China Legal Summit

Mark Steward
Executive Director, Enforcement

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Thank you for inviting me here this morning.

The regulatory frontline has never been a more challenging place, especially here, at the confluence of great rivers of Mainland and global capital, making this 3rd annual summit even far more relevant not only to us as practitioners but to historians too.

Let me talk to you this morning about our approach in general and illustrate it with some recent cases that I think are relevant to anyone looking at the intersections here with the US in particular.

Misconduct risk: The role of detection

Our strategic approach is I think now well-known and is founded, more or less, on the reality that in such swirls and rapids, our ability to assess conduct risk is often relatively unreliable (like predictive text). As a regulator, I am often asked to identify these types of risks in advance. I retreat into a polite shell because I know the chance of being wrong is far greater than the chance of being right. What is more, it is not how we think, when we survey the risk of misconduct in our market and thirdly, having seen other regulators do this, I often think, skeptically, that skillful practitioners of wrongdoing – they exist – pay close attention to what we say we are going to do, so they can make sure they are operating where they know we are not likely to look.

However, the fallibility of our predictive capacity is no excuse for failing to be where the action really is, which means we need to focus more on detection and detective strategies.

One of our key tools is our daily market surveillance programme. It is like radar, giving us daily oversight of what is happening in our markets through a matrix of software applications combined with human intelligence and, given the absence of client ID numbers in our market (unlike the Shanghai market for example), the strategic use of the Securities and Futures Ordinance (SFO) section 181 notices or surveillance inquiry notices. We are currently issuing about 200 of these notices every week – each one an implicit message that we have noticed something and we are watching carefully – and the results feed into all our enforcement programmes, enabling us to be or to appear "always present" across our lengthening frontline of ongoing investigations and litigation.

The "always present" or watchful appearance generates a great deal of work including:

- about 10,000 section 181 or surveillance style notices issued each year or about 200 per week;
- over 420 ongoing investigations across all programmes;

- current insider dealing, market manipulation and market misconduct proceedings on foot against 37 persons;
- current civil proceedings on foot seeking remedial orders against 89 persons;
- a further 70 other criminal charges on foot against 15 persons; and
- 31 disciplinary cases on foot against intermediaries.

The point of all this activity is, of course, a manifold one. We are detecting and stopping misconduct as early as possible often before it has achieved its ends because any symptoms are noticed as soon as they are apparent. Where misconduct has occurred – because of course it always will – and where possible, we seek to tackle the consequences as quickly and as efficiently as we can, including seeking redress. And in all cases where misconduct is established, we seek to vindicate the public interest through sanctions, using litigation to educate the market and to set authoritative precedents for others to follow.

Let me pick out a few recent and relevant cases involving the China-US dynamic.

China Metal Recycling

Last week, the High Court directed that liquidators be appointed over China Metal Recycling, a listed company, in proceedings we commenced in July 2013. This decision – with reasons to be handed down later – was the first time the SFC used section 212 of the SFO invoking the public interest to take control away from a company's senior management.

Like many corporate structures in Hong Kong, the listed company is a holding company for a large number of subsidiaries – 38 in fact – incorporated in the British Virgin Islands, the Mainland, Hong Kong, Macau, Singapore and Taiwan. China Metal Recycling itself is a Cayman Islands entity. The business – as well as the purported business – of the group was carried on by the subsidiaries rather than by the holding company, which meant, in practice, little of the business really existed in Hong Kong itself.

Our concerns followed an intensive investigation into the way in which this business was in fact being carried out. We found the company's pre-IPO track record, its post-listing performance and revenue and profits had been vastly exaggerated and that purported revenue was in fact the result of a sophisticated round robin involving false shipping documents, false accounts, and highly complex round robin transactions across several countries.

The business of the company was a simple one – far simpler than the complex corporate structure constructed to carry it out.

The company claimed it purchased scrap metal, mostly in the US, and either shipped it to the Mainland for sale or produced recycled scrap metal products to order. The nerve centre for this operation appeared to be a Macao entity, called Central Steel Macao – identified in the IPO prospectus as the sourcing arm for identifying scrap metal from international markets. Perhaps Macau may not have been the most obvious place for a sourcing arm to establish itself given that it was focusing on identifying scrap metal sources mainly in the US and the company's central management was in Hong Kong.

We found problems both pre- and post-IPO. Taking its last full year of operation, 2012 as an example, we found Central Steel Macao made 431 payments totaling around US$2.4 billion to its purported key suppliers in the US and Hong Kong. About 98% of those funds were routed to its purported customers and eventually back to Central Steel Macao through a multitude of bank accounts and multiple entities set up in the US and around the world yet controlled centrally within China Metal Recycling. This was an extraordinary feat of organisation, to say the least.

Central Steel Macao also appeared to be a factory for the falsification of thousands of fake documents, invoices, bills of lading and correspondence needed to create the illusion of a real operation.

When we raced to Court in July 2013 to seek the urgent ex parte appointment of provisional liquidators, our main concern was to have the appointments made and recognised in Macau so that the Provisional Liquidators would get control of the Macau office before the company could find out what was happening and either destroy or remove evidence.

The action we have taken so far in this case is primarily to stop the misconduct from continuing, to wrest control of the company away from the current management who had presided over its affairs and to install a liquidator to undertake a clear-eyed assessment in the interests of the minority shareholders and the creditors. On our estimate, the percentage of the company's business that was falsified was increasing rather than decreasing: misconduct was destroying whatever genuine business existed and also shareholder value. So the first step and the best chance of a remedial outcome requires putting in new controllers to assess what is there after the fictitious transactions are stripped out of the accounts.

Further steps will need to be taken here and the story is not yet at its conclusion.

Citron Research and Moody's

Let me turn briefly to two other recent cases that may be relevant to US practitioners – our action against a US-based shortseller, Andrew Left of Citron Research, whom we allege published a false or misleading report on a Hong Kong-listed company after shorting the stock, and our disciplinary case against Moody's, the credit rating agency, over its red flag report on a number of Mainland-based companies listed in Hong Kong.

Both proceedings have garnered some eccentric reactions, including claims that the SFC is seeking to chill independent research into Mainland companies. Nothing of course could be further from the truth.

The Citron Research case involves an allegation of market misconduct, in this case, the publication and dissemination of false or misleading information producing a sudden and volatile drop in price which we say enabled Citron to profit from its short position. If we succeed in proving this allegation – there has been no hearing or findings here so Left is entitled to all the normal presumptions of innocence – we will say it is market manipulation of the plainest kind.

The Moody's case on the other hand does not involve any allegation of market manipulation. It is a disciplinary case, the first we have taken against a credit rating agency since credit rating became a regulated activity in 2011.

Disciplinary cases against intermediaries involve allegations that the firm has breached required standards of conduct eg, poor or substandard work or management practices caused by incompetence, negligence, an absence of adequate systems and controls, or a combination of all these things.

The Moody's red flag report was, by its own lights, a report describing how Moody's assesses corporate governance of Mainland-related companies, all of whom in this case are Hong Kong listed. The report identified a number of so-called red flags in these companies. On publication, the share prices of these entities fell dramatically.

Again, there has been no hearing or findings here and so Moody's is entitled to all the normal presumptions. However, a relevant question, amongst several, to be examined in this case will be whether there was a reasonable basis for these red flags – were they actually red flags or was there a less alarming explanation – as well as the adequacy of the control process over their identification and over the content and publication of the report.

The licence to carry out regulated activities – like credit rating activities – is a responsibility that confers privileges and obligations. It is vital that organisations like credit rating agencies (although not exclusively credit rating agencies at all) that can influence investor sentiment and therefore move markets, have high standards of probity and control over their public statements to ensure there is a proper foundation for them and that there is an appropriate degree of management control and supervision when such statements are made.

Our markets need better quality research – there can be no doubt. And rather than chill research, we have seen more of these reports of late, not only by intermediaries but also from short sellers – Muddy Waters, Emerson, Glaucus, etc, all of whom are US-based, who have issued reports on Hong Kong companies in recent months – to name a few. Glaucus of course issued a report on China Metal Recycling not long before we took action – although I should add this report was not the stimulus for our inquiries. There should be no chill in respect of reports that are soundly and reasonably prepared.

At the same time, the investing public needs protection from the cynical use of false or misleading publications that drive down share prices for the wrong reasons and there should be accountability for shoddy research especially when it affects stability in our markets.

Only wrongdoers should feel any chill from these objectives.

International Work

What should be clear and obvious is that all of these cases require substantial engagement with our regulatory colleagues around the world, especially, in the context of China-US relations, the China Securities Regulatory Commission (CSRC) on the Mainland and the Securities and Exchange Commission (SEC) and the Commodity and Futures Trading Commission in the US. Of course these are not the only cases nor the only regulators who are important in this process. But these cases I have mentioned are rather more typical of the work we are doing.

This brings me to the Shanghai-Hong Kong Stock Connect scheme and our enhanced arrangements with the CSRC that I think are relevant here.

At the moment, assistance between regulators is regulated by the International Organization of Securities Commissions' multi-lateral MOU (MMOU). Each signatory to this agreement commits to the provision of assistance with a limited and defined set of exceptions. It has been enormously successful over the last 10 to 12 years and it remains the mainstay for our dealings with our overseas counterparts on enforcement cases, including the SEC.

However, the MMOU has limitations. It requires signatories to assist when asked to do so but it is less prescriptive and obligatory in respect of unilateral assistance, nor does it require or regulate the need for coordination where misconduct may start in one jurisdiction and infect another.

This is what is at the heart of the Shanghai-Hong Kong Stock Connect arrangement with the CSRC: its leitmotif is not assistance – because that is a given – but coordination, a far more challenging objective and one that will produce stronger outcomes in time. It is time for this kind of coordination to become the leitmotif for all international work.

Coordination is important because – putting it very simply – the worst wrongdoers – and we should always keep the most wily in both mind and view – are not stupid. For those who seek to game markets illegally it is obvious they will set up structures that ensure any implicating evidence is as far out of reach as possible from those public authorities, like us at the SFC, with the most interest in discovering that evidence. We know of organisations that keep sensitive documents in uncooperative jurisdictions. We know of organisations that keep sensitive documents in third-party hands to evade compliance with notices to produce and subpoenae. There are other notorious examples.

Regulators need those Odyssean qualities of wiliness and guile too.

On that note, I will wish you an enjoyable summit. Thank you.