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Hong Kong Securities Institute SFC Executive Directors Series

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Thank you for inviting me again to the Hong Kong Securities Institute's SFC Executive Directors Series. The first occasion was nearly two and a half years ago, in May 2007, in very different economic times. I spoke then about some of the changes we were building into our enforcement practice. I want to talk about what have been the results, especially in the last 12 months, a time of profound global change.

Enforcement approach

There were, effectively, three starting points for our developing approach:

(a) first, an assessment of the SFC's statutory objectives (fair and honest markets, reduction of crime and misconduct, investor protection, to paraphrase three of the six objectives) in the context of what we had been doing as an enforcement agency;

(b) secondly, a recognition that underlying these apparently intangible statutory goals is the financial well-being of and the often devastating impact of crime and misconduct on real people, families, livelihoods, businesses and investors;

(c) thirdly, a desire to diagnose the problems and rectify the harm caused by misconduct efficiently, effectively and without bureaucratic delay.

Underlying all of this is the need for regulatory pragmatics. Even in the most perfectly regulated environment, problems will arise. While reduction of crime and misconduct is, self-evidently, an appropriate regulatory objective, it is also a strategic objective. Regulatory problems will continue to arise. In this way, the measure of a regulator is not the extent to which problems can be avoided, but whether they can be resolved when they arise.

A regulator is part of the solution and not part of the problem.

This leads, inevitably, to the need for a fuller prescription of antidotes. Solving problems means we must develop a spectrum of remedies, specifically, in an enforcement context, chasing down the proceeds of wrongdoing wherever they may be; pulling apart fraudulent transactions; applying for remedial sanctions for the benefit of victims; ensuring those who commit or assist in fraud or misconduct, including those who help hide it from detection, pay for the costs of rectification; and, finally, prosecuting perpetrators and protecting the public from the risk of further harm.

Let me summarise what we have done.

Outcomes, results and resolutions

First, we have been very active in tackling insider dealing using both criminal and civil remedies. There should be no doubt now that the incidence of insider dealing and the impression that it is tolerated, if not tacitly admired, discourages investors and erodes confidence in markets and, if recent studies are right (and my own view is that they are), jurisdictions that are not active in tackling insider dealing see lower levels of liquidity and increases in the cost of capital[1].

We have secured nine criminal convictions with immediate jail terms in five cases inside the span of 12 months. These are the results of the first criminal proceedings for insider dealing in Hong Kong's history and include the first indictable prosecutions under the Securities and Futures Ordinance (SFO). They are also results that could not have been achieved without the Director of Public Prosecutions and his staff who have conducted the prosecution of these cases so efficiently and ably. And we are currently awaiting verdict in another insider dealing case.

These cases, of course, are not a reaction to the global crisis of the last 12 months. The work that led to these cases began more than two years ago with civil proceedings commenced in mid-2007 to freeze, for the first time in Hong Kong, the profits of suspected insider dealing. These orders remain on foot and the defendant has been charged subsequently with insider dealing. His criminal trial is the one in which we are currently awaiting a verdict and, following that verdict, we anticipate we will be taking further steps in the civil proceeding dealing with the alleged profits that remain frozen.

We have made a number of similar applications since mid-2007. The court has made a series of interim orders freezing approximately $100 million in a number of suspected insider cases. We have overcome challenges in one of these actions involving an overseas firm which, if successful, would have left us without a remedy to tackle traders who route illegal orders (and profits) through overseas entities. In this case, the court accepted our argument that the injunction remedy in the SFO is a substantive one in which the court could also compel a wrongdoer to pay compensation. This was a landmark decision confirming our view that this remedy existed where we could establish a contravention of the SFO.

While this decision may yet be reviewed by the Court of Final Appeal, we have since commenced a similar proceeding against a New York-based hedge fund, Tiger Asia. This is an insider trading action involving allegations of manipulation and insider dealing in shares of China Construction Bank, one of the Mainland's largest banks. We are seeking, amongst other orders, an asset freezing order equal to the profit we allege was made in the relevant trading and orders unwinding the transactions and compensating any third parties. Tiger Asia has no presence in Hong Kong nor, as far as we know, does it have any assets but it will now have to defend its conduct in Hong Kong's High Court.

Our indictable criminal actions are not confined to insider dealing. We have recently completed the hearing of evidence in the first indictable criminal trial for market manipulation in which we allege a conspiracy to falsify the price of shares of Asia Standard Hotel. The

[1] North G "The Australian insider trading regime: workable or hopelessly complex" (2009) 27 Companies & Securities Law Journal 310 at 312-315.

effect of the alleged false trading was to increase the capitalised value of the company by $4 billion. This is the first case of its kind in Hong Kong.

We have also developed new remedies in relation to corporate governance issues commencing the first cases to disqualify company directors from being involved in management on the grounds of misconduct and the first cases in which we will be asking the court, for the first time, to order the directors concerned to compensate the company for losses we allege were caused by their breaches.

As there should be no safe haven for insiders who misuse confidential corporate information, so there should be no tolerance for company directors who misuse shareholders' funds for their own or another's benefit.

I should also mention our recent action against the former chairman of GOME and his wife in which we allege breaches of duty and fraud in relation to a share buy-back in early 2008 in which GOME, China's largest household and electronic goods retailer, suffered alleged losses of $1.6 billion. We have obtained an interim order freezing assets in this amount and we are seeking final orders to pay damages to GOME and any third parties for losses incurred as a consequence. This is the largest interim freezing order we have obtained to date.

We have also turned our attention to licensed intermediaries and registered institutions. We have revoked the licence of a substantial leveraged foreign exchange trader (the Hong Kong Forex case). This was the first time we had exercised the revocation power on the basis of continued misconduct. Revocation is no longer a theoretical possibility. We are prepared to put firms out of business where non-compliance is an ongoing problem.

We have also introduced new approaches to stimulate compliance by intermediaries and to curb future misconduct with programmes to impose deterrent sanctions using an accelerated disciplinary process if previously detected issues are not properly dealt with and they re-surface. Finally, we have taken action against a number of licence holders and registered institutions rather than individual staff members to drive home the message that senior management have prime responsibility to maintain relevant standards of conduct.

Our investigations into the sale of Lehman Brothers' Minibonds reflected this approach. While tens of thousands of complaints alleged mis-selling in individual cases, we concentrated on management systems and controls, focusing on the way in which distributors understood the product they were selling, trained the staff who were selling it, understood their customers' financial position and needs and ensured the product was suitable for them. We also examined the ways in which distributors supervised and managed the sale process.

This meant we came to grips with the way in which Minibonds had been sold in a very short space of time. The logistics of this exercise were substantial given the number of banks and the even larger number of branches deployed in the distribution process, the considerable length of time in which Minibonds had been sold (six years) and the large number of people involved in the sale process.

I said last October[2] that our objective was to respond to the maximum number of Minibond complaints in the shortest possible amount of time and we have done that well before the first anniversary of Lehman's demise.

In the midst of this heavy traffic, we also intervened in the privatisation of PCCW Ltd leading to a landmark decision by the Court of Appeal. In this case, the shares of a populous minority, largely small investors, were to be compulsorily expropriated by means of a scheme of arrangement. There was good reason for us to suspect that share-splitting had distorted the outcome of the shareholders' meeting and that the foundation for court approval had not been satisfied. It was no surprise to see the court scrutinise the details of a scheme in which property was to be expropriated from small investors with the greatest of care. The decision of the Court of Appeal vindicated our intervention and confirmed the authority of the court in these types of matters[3]. The whole affair was a significant test of our capacity to tackle highly complex problems quickly enough to make a difference.

Returning to the Minibond agreement, the attention has focused on the repurchase offer under which over 90% of investors will receive, on acceptance of the offer, at least 60% of their investment and, in all likelihood, by the end, 70% and if the collateral returns are greater than 70% then the banks will pay the extra amount, dollar for dollar. Recent data from the banks indicates that acceptances are running at just under 100%.

But from a regulatory point of view, this agreement is much better than the dollar value of the return to investors. First, the banks have agreed to pay for a review of their sale processes according to detailed specifications set down by the SFC. The outcome will be a re-engineering of management systems and controls intended to ensure distributors are equipped to meet the highest standards and to reduce the risk that this kind of controversy will affect our market again. Secondly, the agreement requires each bank to adopt an enhanced complaints handling process to deal with complaints in respect of all other structured products. The banks remain at risk that our top-down investigations will lead to enforcement action if this process does not produce effective resolutions for customers.

This does not mean the SFC will take up customer complaints as a matter of course. If a customer refuses reasonable offers to resolve complaints, the SFC will not intervene. We are not mediators or arbitrators.

Finally, the banks have agreed to forgo the commission income they earned in selling the product to create a fighting fund to bring back the collateral to Hong Kong. The fighting fund will be substantially greater than the amount committed by banks earlier for this purpose.

Remember a little over six months earlier, the original buy-back offer looked dead in the water. The July agreement has turned this right around. Now there is a scheme to give investors back a substantial portion of the money they have lost, the prospect for additional top-ups, funding to repatriate the collateral, programmes to re-engineer sales systems and resolve complaints about other structured products. In a real sense, banks and Minibond customers are now on the same side. And that is a welcome return.

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[2] Keynote address at 4th Annual Wealth Management Conference, "Mis-selling: Consequences at a Glance" 23 October 2008

[3] PCRD Ltd and Starvest Ltd, the offerors, have indicated they will seek leave to appeal to the Court of Final Appeal.

These types of outcomes can only be achieved by regulators who are able to operate independently and who are committed to taking into account all relevant points of view but also to resist sectoral interests and influences, from wherever they may come, to prevent them from determining the outcome. We must remain impartial and loyal to our statutory objectives first and foremost to achieve fair and just resolutions.
Our programmes are now in a period of consolidation rather than dramatic change. We will continue to develop our remedies further and use them to the utmost to diagnose problems and rectify the harm caused by crime and misconduct in our markets.

Thank you.