

SFC Enforcement and Fraud Speech at Conference on Fraud Risk Management

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Thank you for inviting me to participate in this conference.

The Securities and Futures Commission (SFC) regulates Hong Kong's securities and futures markets.

Our objectives are set out in plain language in our legislation. We are required:

- to maintain and promote fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry;
- to promote understanding by the public of the operation and functioning of the securities and futures industry;
- to provide protection for members of the public;
- to minimize crime and misconduct; and
- to reduce systemic risk and assist the Financial Secretary to maintain the financial stability of Hong Kong.

Each of these aims is a self-evidently important objective and culminates in an overarching objective, namely the financial stability of Hong Kong.

Each objective also expresses an intangible ideal of economic and public policy.

However, in a practical sense, these intangible objectives disguise very tangible concerns: real life underlies our statutory objectives, the financial well being of real people, families, livelihoods and businesses.

In our enforcement work, on a daily basis, we see how securities and market fraud and misconduct affect the lives of ordinary people, families and businesses. And the experience is an important one.

The traditional enforcement approach is to identify and prosecute the wrongdoer. This is a challenging proposition in itself. However, what I would like to propose to you today is that it is not sufficient alone to maintain market confidence, a sense of fairness and orderliness as well as protection for members of the public – to mention some of our just-mentioned statutory objectives – if the harm and damage caused by the wrongdoing remains unchecked and unremedied.



For this reason we are deeply engaged in not only sending deterrent messages, where appropriate, but also in remedying the consequences of securities market fraud and misconduct on the lives of real people and businesses.

Fraud is pernicious because it sucks in not only the gullible and the susceptible but also the experienced. The Wall St Ponzi prince, Bernie Madoff, conned not unsophisticated mums and dads but experienced if not professional investors, seasoned banks and financial institutions as well as regulators. If not for the state of global markets in 2008, Madoff might well be still in business.

The way in which fraud can make fools of the best of us succinctly describes the problem of fraud.

There is an additional element to fraud in securities markets that differs from the kind of Ponzi scheme frauds perpetrated by Madoff and others. Part of Madoff's technique was intimately bound up with his ability to make clients or potential clients believe and trust him. On stock exchanges, transactions are conducted quite differently. There is no face-to-face contact. It is inevitable that you will not know the identity of the person with whom you are trading. What's more it can be hard, even for experts, to tell the difference between a genuine trade and a manipulated transaction.

Just the other day two traders were sentenced to terms of imprisonment for manipulating the market for a number of derivative warrants. The scheme involved the two colluding to trade the same warrants in much the same sized parcels at much the same prices. The effect of this conduct was to make it look as though these securities were popular, in hot demand, when in fact nothing could have been further from the truth.

This case is a perfect example where the victims, in this case, the purchasers, would have been entitled to believe there was a liquid market for these warrants when in fact, there is no real market at all. They bought warrants that could not be sold or at least only sold at a loss not knowing, when the losses crystallized, that their loss was not the result of a poor investment decision but because of a trick played on them by the two perpetrators of the manipulation.

The anonymity of the market together with the subtlety of manipulative techniques can combine to mask fraud in a very convincing way.

So what is to be done?

The response to fraud, and the SFC's response to crime and misconduct in our markets, is to employ the full spectrum of remedies, both criminal and civil, not only to send deterrent messages but also to bring the law to bear on resolving the consequences of misconduct.

The greatest antidote to fraud is uprooting it once discovered and remedying the consequences. Of course I am not ignoring the wrongdoer. But I am arguing that concentrating on the wrongdoing alone is not enough to maintain confidence, orderliness and fairness in our markets if it means the wrongdoing and the harm and damage it has caused remains unchecked and unremedied.



This analysis means the prescription must include broad civil and criminal remedies to chase down assets and proceeds wherever they may be; to apply for remedial sanctions for the benefit of victims; to ensure those who assist in fraud and misconduct, including those who help to hide it from detection, are made to pay for the costs of rectification and finally the prosecution of perpetrators.

Let me give you some snapshots as to what this means in practice.

Since 2007, the demands of our work have not only grown, they have surged.

The number of cases we are taking on has risen by over 100%. A higher percentage of these cases are complex meaning they involve:

- more than one issue;
- multiple resources and professional skills;
- novel or complex regulatory policy, legal issues or require innovative solutions;
- substantial involvement of senior management; and
- give rise to significant issues of public interest.

The increase of complex work in particular has driven a multi-lateral approach, including both criminal and civil remedies to tackle both wrongdoers and the wrongdoing i.e. its impact and consequences.

First, we have commenced a number of civil cases dealing with the financial impact of market misconduct. Examples include:

- proceedings against 11 defendants involving the Descartes Athena Fund SPC (the Athena Fund) a private hedge fund which raised over US\$100 million where we have obtained court orders freezing US\$90.6 million and a further sum of HK\$160.8 million. The SFC's case involves allegations that false statements of account and false subscription contracts were issued by the fund administrators to investors. We asked the court to appoint administrators over some of the companies so that pending trial all relevant assets are identified and properly protected. If successful, the SFC's action will ensure investors are able to make the maximum possible recoveries.
- proceedings involving the former chairman of GOME Electrical Appliance Holding Limited in which we have obtained an interim injunction freezing HK\$1.65 billion in assets pending a trial raising issues about a share buy-back scheme which we allege facilitated the repayment of a personal loan owed by the former chairman. We are seeking orders directing those moneys to be paid to the company to cover the losses we say the company suffered;
- a number of cases in which we have commenced proceedings against listed company directors whom we allege breached their duty to the company or misused company assets for their own or another's benefit where we are also seeking directions that the company brings proceedings against those directors for compensation. The first of these cases was recently completed and the court disqualified the directors for misconduct and directed compensation proceedings to be commenced against them. The company has now commenced those proceedings. We have a number of similar



cases on foot including cases where we are also asking the court to make a compensation order in our proceedings so as to save the time and expense of further litigation dealing with the same subject matter.

- proceedings against US hedge fund Tiger Asia Management LLC over allegations of insider dealing in two bank stocks in which we are seeking a range of orders including an injunction preventing the fund from trading in Hong Kong and reversing the transactions which we allege contravened the law;
- a series of proceedings where we have applied for and sought orders freezing the alleged profits of insider dealing. We have obtained interim injunctions totaling approximately \$100 million and we are now preparing cases for trial in which we will test the circumstances in which the court will unravel and reverse insider dealing transactions, returning shares or money to counterparties and/or compensating victims;
- our recent action to obtain an interim injunction freezing almost HK\$1 billion being the net IPO proceeds of recently listed company, Hontex International Holdings Company Limited, pending completion of the investigation into whether the company's financial position was fairly set out in the IPO prospectus. If our concerns are established we will seek orders to return the frozen capital to shareholders.

While perhaps not in the same category as market misconduct and fraud, the same approach also drives our enforcement of the Code of Conduct for Persons Licensed by or Registered with the SFC (the Code of Conduct) which regulates conduct of business by intermediaries and the results were seen in the agreements we initiated and concluded last July with the 16 banks in relation to the sale of Minibonds in which over \$5 billion has been paid out by banks in repurchasing those failed securities.

It can also be seen in the probationary suspensions we introduced for intermediaries. In these cases, the firm enters into a three pronged agreement in which first, a public reprimand is imposed, secondly there is rectification of the harm caused by identified wrongdoing, including payment of financial redress to affected customers and thirdly an agreement to a fixed period suspension which is triggered if the same identified failings arise again. The three components deal with the **past** misconduct, remediate the **present** consequences of the misconduct and provide adequate assurance for the **future** through the mechanism of the probationary suspension.

Secondly, we have commenced more actions designed to send a stronger deterrent message to those who may be tempted to defraud the market. These cases include:

- 10 convictions for insider dealing, since July 2008, including a seven year jail term imposed on Du Jun (who is appealing both the verdict and the sentence). The seven-year imprisonment for Du Jun is the longest in the world for insider dealing; and
- the first indictable prosecutions for market manipulation including the first convictions for conspiracy to manipulate the market followed by jail terms.

Thirdly, while global market conditions are partly responsible, we have deliberately increased our work rate to make it more likely wrongdoers will be caught and identified.



Our market surveillance team is initiating over 350 inquiries into suspicious trading activity every month.

Our investigation, disciplinary and legal teams are conducting double the number of cases we took on in 2007.

Our international team is handling more requests for assistance with overseas agencies i.e. request that where we are seeking assistance from other regulators to investigate suspected misconduct in Hong Kong.

On every measure we are more productive, efficient and active in the work that is in train and in the outcomes we are seeking.

Our determination to catch more offenders means we are digging deeper into cases to find explanations to replace suspicion, to find answers wherever possible.

Let me give you two examples arising from the insider dealing cases that were prosecuted last year.

In July 2009, following guilty pleas, Allen Lam Kar Fai, a former investment banker and Ryan Fong Yen-hwing, a former portfolio fund manager, were convicted of insider dealing in the District Court.

The evidence was that Lam's employer, a bank, acted as financial adviser for a purchaser of a listed company. Lam knew about the pending offer and gave the information to his friend, the fund manager who bought shares in the target ahead of the announcement.

On the outside, it looked coincidental. There was no direct evidence that the inside information had been communicated by the banker to the fund manager. However, there was a series of emails between the two, which, although they did not mention the deal or the target, did speak mysteriously about the purchase of a French car.

The SFC contended that the "French car" was a code for the pending offer for the target company and that the progress of the purchase of the French car, including information about the price of the car mirrored developments in the confidential negotiations between the bidder and the target company.

The second case involved the prosecution of Du Jun. In that case, the prosecution case was that the inside information was contained in an internal Morgan Stanley email sent to Du Jun early on the morning preceding his first purchase of CITIC Resources shares. Du was a Managing Director of Morgan Stanley in Hong Kong.

Du denied he read the email although he clearly had access to it on his Blackberry.

For those of you who have or are familiar with Blackberries, you will know that when you open an email you receive a single screen shot of information and you roll a ball to scroll down the page to read the email. In fact the initial screen shot contains 2048 bytes of data and as you scroll down you invariably have to request the Blackberry for more data. Forensic examination of the Morgan Stanley Blackberry server showed that the server retains metadata or information about the way in which the user has used the Blackberry:



first, it issues a unique identifier and logs the time when an email is sent, second, it identifies and logs the time when an email is opened and thirdly, it identifies and logs when a request for more data is sent by the user. In effect, the server was able to demonstrate when the email was opened on Du's Blackberry. Importantly, the successive requests for more data could only be explained if the user not only opened the email but also read its contents from the top to the bottom.

I should add Du is contesting both his verdict and his conviction in an appeal.

In conclusion, I want to reiterate three points.

First, we cannot eliminate fraud and so we must be prepared to deal with fraud which means we should possess, in our arsenal, the remedies to deal with the consequences of fraud.

Secondly, it is not enough to identify and take action against wrongdoers. The harm caused by fraud will continue to blot the system and undermine confidence and fairness unless it is checked and remedied as expediently and as effectively as the law allows.

Thirdly, the antidote includes both civil and criminal remedies to upend fraud by the roots, remedy its consequences and take action against the wrongdoers.

Thank you.