SFC 證監會

ENFORCEMENT REPORTER

A bi-monthly communication between the SFC and the market about the SFC's enforcement work and current enforcement issues.

JULY 2007

Highlights

- The SFC has succeeded in the first Court action in Hong Kong against a director for misconduct or misfeasance under the SFO
- The SFAT upholds the SFC's approach to the Securities & Futures (Financial Resources) Rules but overturns our decision on 'locking'
- The Court considers jail terms for market misconduct
- The SFC says goodbye to warning letters

The Current Issue

Welcome to our redesigned SFC Enforcement Reporter. The new look Enforcement Reporter contains more information about our recent cases and new areas such as Enforcement Policy and Practice which will tell you about developments and changes in our thinking and approach.

The aim of all these changes is:

- to explain the regulatory benefits of our actions;
- to help build stronger compliance practices and attitudes;
- to develop better access to our thinking and the regulatory benefits of our actions;
- to help suppress crime and misconduct in our markets; and
- to encourage constructive debate.

We will not talk about every action we have taken in the preceding period. Instead we will highlight major themes, trends and undertakings in our work. We intend to publish the Enforcement Reporter every two months rather than every month. We look forward to your comments and feedback.

Director Misconduct in the Frame

The SFC recently went to the High Court seeking orders for the first time against a former listed company director for misfeasance or misconduct under the SFO (see *Securities and Futures Commission v Yick Chong San* [2007] HKCFI 518).

Key Facts

Central to the SFC's case was Yick's decision to pledge $10 million of the company's money to secure a loan for certain third parties. The third parties who received the benefit of the deal defaulted on their obligations and the company was obliged, under the terms of the pledge, to repay the lender. This led to a substantial loss amounting to approximately 20% of shareholders' funds.

The crucial issue was not the loss of money but that the deal was simply not in the interests of the company at all.

Key Issues

The decision sets an important benchmark for corporate conduct and highlights the following key issues:

- listed company directors are under a duty to make themselves familiar with the relevant rules, to seek advice and take that advice into account to ensure the company conducts its affairs properly;
- listed company directors may be guilty of misconduct or misfeasance if they breach GEM Rules and other listing rules concerning corporate governance and disclosure;
- listed company directors must satisfy themselves that investment decisions are in the interests of the company and are not made for the purpose of helping friends, associates or family members;
- the Court will impose disqualification orders bearing in mind the seriousness of the allegations;
- the Court's power to disqualify a person from being a company director on the basis of misconduct or misfeasance is designed in part to deter other company directors from making the same mistakes; and
- disqualification orders can restrict a person from being a director or involved in the management of **all** companies, not just listed companies.

The Court ordered that Yick not be a director of a listed company or any subsidiary or affiliate of a listed company or involved in the management of such a company, without leave of the court, for a period of four years. The Court set the four-year period taking into account the serious nature of the allegations and the need for deterrence. The length of the disqualification period would have been longer but for the fact that Yick co-operated with the SFC.

If you want to find out more about this case, please follow this link which includes a complete statement of the agreed facts presented to the Court.

The SFC has recently commenced another case seeking disqualification orders against five former listed company directors (see SFC press release dated 30 March 2007, 'SFC Seeks Disqualification Orders Against Former Directors of Failed Listed Company'). The SFC will continue to pursue cases where corporate governance standards have fallen below the level required by Hong Kong law.

FRR Safeguards Investor Protection

The Securities and Futures Appeals Tribunal (SFAT) recently examined the important role of the Securities and Futures (Financial Resources) Rules (FRR) and the responsibilities of a firm's Responsible Officer (*Cheung Wah Fung Christopher and Christfund Securities Ltd v SFC*, SFAT No. 12 of 2006, 16 April 2007).

Key features of the SFAT decision include:

- the FRR provisions are not mere technical requirements but necessary components of a regulatory system designed to protect the interests of investors;
- the key to compliance is ensuring a proper system of organisation is in place which can be monitored and controlled effectively by the Responsible Officer;
- it is no excuse for a Responsible Officer to direct blame for non-compliance on accounting staff employed by the firm; and
- even though there was no financial loss in this case, a breach of these provisions represents an "assault on market integrity".

The SFAT affirmed the SFC's decision to issue a public reprimand to Christfund Securities and its Responsible Officer, Mr Cheung Wah Fung Christopher, and to impose fines of $450,000 and $50,000 respectively for FRR breaches and supervisory failures. In doing so, the SFAT commented that it was tempted to increase the penalties given the circumstances of the breaches and the serious consequences on market integrity that flow from FRR breaches.

The SFC has issued several reprimands and fines to firms and Responsible Officers in the last few years for FRR breaches In every case, the failure could have been avoided with appropriate policies, controls and procedures in place, including careful monitoring of the firm's financial exposures and, together with an appropriate risk assessment framework, prudent anticipation of demand for margin facilities. Proper systems and controls must include systems to monitor not only day to day demands on liquid capital but also likely and planned demands in the future.

If you would like to know more about this decision, please follow this link to the SFAT determination.

Sentencing for Market Misconduct

The SFC has been involved in a number of criminal actions recently involving market misconduct and the imposition of jail terms has arisen in sentencing.

While there have been very few jail terms imposed for market manipulation, some recent remarks indicate that past sentences may not be as reliable a guide as other factors when it comes to criminal sentencing for market misconduct.

In March this year, the Court of Appeal dismissed an appeal against conviction and sentence brought by Mr Zou Yishang for creating a false or misleading appearance of active trading in certain shares (see *The Securities and Futures Commission v Zou Yishang*, HCMA No. 859 of 2005). Zou had been sentenced to four months' imprisonment and he argued this sentence was wrong in principle because it departed from the "usual" sentences imposed for this kind of offence which were generally "non-custodial".

The Court of Appeal rejected the argument that past non-custodial sentences set a benchmark for this type of misconduct and said:

- it cannot be said manipulation would not "normally" attract a jail term;
- comparisons with other like cases (including earlier cases) are not of great assistance; and
- what is important is an appreciation of the facts and circumstances of each case.

In Zou's case, the Court of Appeal was satisfied the manipulation had a material effect on both the price and turnover of the shares in question and given the sustained course and volume of trading, a jail term was not excessive or wrong in principle.

Since this decision, the SFC has prosecuted Mr Wong Kai Wing in Eastern Magistracy for a similar offence. Wong was also sentenced to four months' imprisonment (suspended for 18 months). He was also fined $200,000 for manipulating the market. In Wong's case, the SFC alleged Wong's course of conduct was sustained over a period of time affecting both turnover and price.

These cases demonstrate, as the Hon Mr Justice McMahon said in Zou's case, that:

> "The protection of the integrity of the stock market is an important public concern in Hong Kong and deterrent sentences, depending on the facts of an individual case, are justified."

If you would like to know more about the Court of Appeal's decision, please follow this link.

If you would like to know more about the suspended jail sentence on Wong, please follow this link to our press release dated 4 July 2007.

Cold Calling and Locking

The SFC has again taken action in recent cases attacking cold calling by staff of Tanrich Futures.

The SFC banned Mr Sze Fan Hoi, a former team leader at Tanrich Futures, from re-entering the industry for seven months; suspended Ms Leung Wing, a former representative, and Mr So Chi Kit Bowie, a team leader, and Ms Chow Yin Shan, a team leader, for nine weeks, six months and eight months respectively.

Each of these cases also involved clients being given 'locking' advice. 'Locking' involves a client freezing a loss-making position so as to stop the loss from crystallizing. The strategy is meant to give the client an opportunity to make good the loss with further trading. (Trading loss will be incurred once a pair of locking positions is put in place. Further trading profits or losses are independent to this pair of locked positions) In the SFC's view, 'locking' increases transaction costs, offers no risk management benefits over closing a position and does not increase the likelihood of profits from continued trading.

In the case involving Leung, the SFC alleged she had given inappropriate advice to a client over locking. This allegation was reviewed by the SFAT and overturned. The SFAT commented that if the SFC believes 'locking' is inappropriate then it should move to ban the practice.

The SFC accepts the SFAT's view that, on the facts of this case, there was not enough evidence to find Leung gave inappropriate advice to her client. However, the SFC does not believe that trading strategies, however risky they may be, should be the subject of specific bans by a regulator. Instead, the Code of Conduct obligation is on the adviser to ensure that a recommended trading strategy is reasonably appropriate for a client. The SFC continues to be concerned about the practice and will continue to bring cases forward where there is evidence that:

- the adviser has not explained clearly the consequences of 'locking' to the client; and
- the adviser has failed to check the client has the financial means to pay for the costs of further trading including the potential of further losses, and that such costs and losses are suitable given the client's financial and investment objectives and tolerance for financial risk.

If you would like to find out more details concerning the SFAT's reasoning on the issue of 'locking', please follow this link to the SFAT determination.

The SFC has recently issued guidance to investment advisers about the conduct requirements involved in giving suitable investment advice. If you wish to view this guidance, please follow this link to the SFC's website.

Disclosure of Interests

Under Part XV of the Securities and Futures Ordinance, listed company directors, chief executives and substantial shareholders have obligations to disclose and notify the listed company and a relevant exchange company about prescribed changes of interest. The SFC considers these obligations are important because:

- timely disclosure of interests and changes of interests assists in making the market more transparent to the investing public;
- the disclosure of such interests and their changes increases confidence in the market and promotes efficient disclosure practices and disciplines; and
- timely disclosure helps suppress insider trading.

From 1 April to 30 June 2007, the SFC has prosecuted 13 entities in which:

- 10 defendants pleaded guilty receiving fines of $1,000 to $16,000; and
- Three defendants contested the case and were found guilty receiving fines of $10,000 to $30,000.

Enforcement Policy and Practice

Good-Bye Warning Letters

For many years the SFC has issued warning letters in response to minor matters in circumstances where the issue and its consequences did not justify taking formal enforcement action. In the last financial year, for example, the SFC issued approximately 200 warning letters.

We are redesigning the warning letter and its contents to remove the notion that the letter is an informal disciplinary sanction or reprimand. Despite clarifying on a number of occasions that the SFC did not regard a warning as a formal sanction, we continued to receive feedback from people telling us they found warning letters unfair.

We are responding to the feedback by changing both the name and the content of our letters. From now on, they will be called compliance advice letters. They will not contain adverse findings of fact, nor will they be used against a person as evidence of a prior breach or as an aggravating factor when deciding penalty in any formal disciplinary proceedings. Instead, the SFC will use the letter to address areas of regulatory interest and to raise standards of conduct and compliance in the future.

The Enforcement Reporter will include, as a regular feature, a section on areas of regulatory concern that we have discussed in our compliance advise letters (on a no-name basis).

Feedback

We encourage comments and feedback about the changes in our new Enforcement Reporter as well as any feedback in relation to any of the issues we have raised. We will discuss the feedback we receive and, where called for, provide a response to your questions and comments.

Please send all feedback to enfreporter@sfc.hk. We value your comments and will consider them carefully.

If you want to know more, the SFC's press releases are available at www.sfc.hk.

If you want to subscribe and receive the Enforcement Reporter monthly by email, simply register for the SFC's Website Update Email Alert service on our homepage and select Enforcement Reporter. Intermediaries licensed by the SFC receive the Enforcement Reporter bi-monthly via their FINNET email accounts.

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