

Highlights

- Over 30 significant enforcement outcomes including a first-ever custodial sentence and urgent actions freezing assets and profits in two ongoing insider dealing investigations
- New approach to resolve outstanding disciplinary proceedings against licensed firms
- Substantial efficiency gains in our investigation work over 2007
- SFC wins four separate challenges to our investigation powers
- Key decision from SFAT affirming application of civil standard of proof in disciplinary cases

What Have We Been Doing?

We are committed to reducing crime and misconduct in the securities and futures markets by:

- identifying risky conduct and circumstances that may lead to misconduct in the future; and
- taking formal enforcement action where we believe it is necessary.

Since the last Enforcement Reporter, we have written compliance advice letters to more than 30 licencees and other market participants about conduct which we believe runs unnecessary legal and regulatory risks or may lead to crime or misconduct in our markets.

The vast majority of these letters reflect concerns about specific internal systems and controls within firms. Adequate internal systems and controls provide the best protection for firms and clients against crime and misconduct. We discuss below cases where we have detected inadequate systems and controls.

We have also completed nearly 30 enforcement cases and commenced civil proceedings in current investigations protecting money and other assets from dissipation.

Disciplinary Proceedings Resolved Using New Approach

The SFC recently entered into an agreement with South China Capital Limited and South China Research Limited resolving a number of outstanding disciplinary proceedings.

This agreement reflects a different approach to the way in which the SFC will give effect to its regulatory objective of minimizing misconduct. Under this approach, the SFC will suspend or postpone the imposition of formal disciplinary sanctions if the firm agrees to an independently conducted review of its activities without prior notice. The formal disciplinary sanctions are postponed unless misconduct of the same kind that led to the disciplinary proceedings can be established.

While the SFC has used independent reviews before as a way of resolving cases dealing with internal systems and controls failings, these reviews have been conducted on a 'with notice' basis. A surprise review is a more meaningful test of

whether the firm is on top of its internal control systems.

Under this approach, if conduct does not improve and past failures reoccur, the firm agrees not to contest the originally proposed, or perhaps more severe, penalties and/or suspension/revocation of licence.

In this case, South China will allow its systems and controls to be tested by an independent reviewer within the next three years.

Under the agreement, the proposed suspension in this case will only be imposed if South China is unable to prevent a repetition of the original misconduct.

This kind of agreement is a positive and forward-looking one. South China and its senior management have refreshed their compliance systems. South China's decision to accept this agreement demonstrates a strong commitment to compliance and to the prevention of misconduct. This should also give confidence to South China's current and prospective clients as well as to the market.

The SFC will pursue this kind of option in other cases where it is appropriate and where it appears to the SFC there is a real commitment to ensure past mistakes are not repeated. (By contrast, see the cases referred to below under "Poor Internal Controls Persists").

For further details please follow this link to our press release dated [19 December 2007](#).

SFC Freezes Property and Assets of Suspected Insiders

The SFC has made two separate applications under section 213 of the Securities and Futures Ordinance seeking urgent interim freezing orders over money and other property. These orders prevent assets and property held by or on behalf of persons suspected of being involved in insider dealing from being dissipated during the SFC's ongoing investigations.

Before making orders like these, the Court needs to be satisfied there is a prima facie case against the defendant and that there is a risk assets will be dissipated unless a protective order is made. The Court will generally seek to balance the public interest for the orders with the specific needs of the defendant.

In the first case, the SFC took action against "A", a person whose name is suppressed by order of the Court. The SFC is currently investigating whether "A" committed insider trading.

In this case, the SFC sought to freeze an amount that was equal to a potential financial penalty that might be imposed through an SFC disciplinary process (the amount would also be sufficient to enable a profit disgorgement order imposed by the Market Misconduct Tribunal to be paid). In that case, the court ordered an amount of \$46,595,033 be frozen, being twice the notional profit earned by "A" in the trading under investigation.

"A" subsequently sought to overturn this order. His challenge failed in a decision that was published on the Judiciary website on [18 December 2007](#).

"A" is now seeking to appeal this decision.

In another case, the SFC has taken similar action in the High Court against another person, "B", whose name is suppressed

by order of the Court. The SFC took the action because it appears “B” is involved in insider dealing. The details of this case cannot be disclosed yet as “B” resides in the Mainland and has not been served with the SFC’s application or the Court order.

Investigations are continuing in both cases.

The SFC will continue to make applications of this kind to the Court under section 213 where there is a prima facie case of misconduct and there is a risk that a relevant person will abscond or dissipate assets.

First Jailings under the SFO

On 7 December 2007, the Court for the first time imposed an immediate custodial sentence for an offence under the Securities and Futures Ordinance.

Mr Ho Lai was charged with 14 offences of market manipulation and was jailed for six months despite his admission of wrongdoing and his plea of guilty (his sentence was reduced because of his early co-operation).

This decision is very significant in that :

- it confirms that market manipulation will be treated seriously by the courts;
- an immediate custodial sentence is on the cards for market manipulators; and
- it sets a sentencing benchmark for other market manipulation cases.

For further details please follow this link to our press release dated [7 December 2007](#).

SFC Improves Investigation Efficiency

The Ho case demonstrates the SFC’s renewed commitment to improving its investigative efficiency by targeting the completion of most investigations within seven months.

Ho, who was jailed in December 2007, committed his last offence in December 2006. This means Ho’s misconduct was detected, investigated and then prosecuted successfully within 12 months of his misconduct.

This is important to ensure suspicions are laid to rest quickly, innocent suspects are cleared promptly and, in cases like Ho’s, for action to be taken before Courts and Tribunals as soon as practically possible.

During 2007, the SFC has aimed to complete most of its investigations within seven months. At the start of 2007, the SFC was completing 36% of its investigations within seven months. By December 2007, this figure had improved to 71%. The vast majority of these cases are cases where enforcement action has been, or the SFC anticipates enforcement action will be, taken.

SFC Wins Challenges to Investigation Powers

In driving the investigation process more robustly, the SFC has faced a number of collateral challenges brought by or against the SFC in the High Court. There have been four formal challenges and a number of threatened challenges that did not materialise.

The courts have ruled in the SFC's favour in all of these challenges, at first instance.

Three of the four cases involve persons refusing to attend an interview at the SFC's offices or refusing to answer questions unless their demands were met.

In one case, a person left Hong Kong for the Mainland on two separate occasions. The SFC ultimately obtained orders from the High Court leading to his arrest at the border and his imprisonment before he undertook to be interviewed by the SFC.

In another case, the SFC sought to make an audio recording of an interview with a person under investigation. The person under investigation claimed this was beyond the SFC's power and launched a legal challenge against the SFC. The SFC contended an audio recording would facilitate the interview process and was more useful than a written record. The SFC also maintained that an audio recording would permit a more accurate transcript to be prepared. The matter was resolved in the SFC's favour by the High Court.

The SFC will continue to pursue its enforcement activities with both fairness and expediency firmly in mind.

We attach links to more information relating to each of these unsuccessful challenges to the SFC's enforcement work.

Please see SFC press releases dated [1 November 2007](#), [2 November 2007](#), [5 November 2007](#) and [18 December 2007](#) for details.

The SFC will continue to meet all challenges to its enforcement activities head on.

Key Decision in SFAT

In a recent case, the Securities and Futures Appeals Tribunal (SFAT) held that:

- the civil standard of proof, allowing for flexibility in respect of the seriousness of the issue, should be used before the SFAT and in any SFC disciplinary proceedings; and
- SFC disciplinary proceedings are civil in nature for the purposes of the Hong Kong Bill of Rights.

In *Application for Review by Mr Lee On Ming, Paul (SFAT Application No 4/2007)*, it was claimed that the SFC's disciplinary process should be characterised as a criminal one and so the higher criminal burden of proof should be applied rather than the lower civil burden of proof. The SFAT disagreed and upheld the orthodox view that disciplinary processes that are not applicable to the general population and are restricted to a defined group, such as licensed persons, will not usually be characterised as criminal unless the penalty can lead to loss of liberty (which is not the case here).

Mr Lee has filed an appeal against the SFAT's decision which has not yet been heard.

For more details about this case, please follow this link to our press release dated [13 November 2007](#).

Poor Internal Controls Persists

The issue of poor internal controls was in sharp focus in six cases recently where protection of client assets were at the heart of the issue. In some of these cases, where it appears misappropriation has occurred, the SFC has referred the case to the police for criminal action where:

- a former licensed representative was prosecuted by the police for theft and fraud, and was sentenced to six months' imprisonment. He was also banned from re-entering the industry for life by the SFC; and
- a sole proprietor of a now collapsed firm was arrested by the police and was convicted of conspiracy to defraud. This case involved client assets valued at \$32 million. Sentencing has been adjourned pending the trial of two other defendants in the case.

The SFC has the power to issue restriction notices against firms where poor internal controls are identified. The SFC recently issued a restriction notice in respect of Great Honest Investment Company Limited. The restriction notice prohibits the firm from carrying on all activities for which it is licensed, disposing of or dealing with any assets held by it or held on behalf of its clients without the SFC's prior written consent. On application by the SFC, the Court appointed an administrator to administer the property of the firm and two other companies owned by the firm's majority shareholder, and granted injunctions and prohibition orders. These actions were premised on an absence of adequate systems and controls to safeguard client assets.

If you would like to know more about the Great Honest case, please follow these links to our press releases dated [12 November 2007](#), [16 November 2007](#) and [23 November 2007](#).

For the rest of the cases, please see press releases dated [16 October 2007](#), [23 October 2007](#), [24 October 2007](#), [19 November 2007](#) and [22 November 2007](#).

Disclosure of Interests

The SFC continues to highlight the importance of the obligation on directors and substantial shareholders to make timely disclosure of their interests in listed companies. Under Part XV of the SFO, listed company directors, chief executives and substantial shareholders are required to disclose and notify the listed company and the exchange company about the prescribed changes of interest.

From 27 October 2007 to 2 January 2008, the SFC prosecuted seven entities. In each case, the defendant pleaded guilty. Fines were imposed ranging from \$ 5,000 to \$72,000.

Enforcement Policy and Practice

Co-operation with the SFC

In March 2006, the SFC published a Guidance Note entitled Co-operation with the SFC. This Guidance Note explains the SFC's approach where regulated persons co-operate with disciplinary proceedings.

The most common ways of co-operating with the SFC are:

- not disputing findings of fact;
- showing remorse for improper conduct;
- consenting to the SFC's enforcement decision; and
- taking remedial steps to rectify problems and/or to compensate clients' loss.

As the Guidance Note explains, each case will turn on its facts and so it is not possible to indicate in percentage terms the penalty reductions awarded for particular kinds of co-operation. That said, care will be taken to ensure that co-operation is acknowledged and credit given in a consistent and equitable manner in each case.

Absent extraordinary circumstances, the maximum reduction of a disciplinary sanction will either be a reduction of the type of sanction by one order of magnitude (for example, from a revocation of a licence to a suspension) or 33%. As a general rule, the earlier, the more spontaneous and the more extensive the co-operation provided to the SFC, the greater will be the credit given for it.

The SFC encourages regulated persons to co-operate to the fullest extent possible and repeats the pledge, contained in the Guidance Note, to continue to reward co-operation.

The Guidance Note on Co-operation has been in operation for almost two years. We welcome any comments, suggestions or ideas about this policy which we will be pleased to consider.

The Enforcement Reporter is available under 'Speeches, Publications & Consultations' – 'Publications' of the SFC website at <http://www.sfc.hk>.

Feedback and comments are welcome and can be sent to enfreporter@sfc.hk. We will consider the comments and, where called for, provide a response.

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