

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

What have we been doing?

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

- identifying risky conduct and circumstances that may lead to misconduct; and
- taking necessary enforcement action.

From 1 December 2009 to 31 March 2010, we sent out 71 compliance advice letters when we became aware of conduct that presented unnecessary risks or that might lead to crime or market misconduct.

During the same period, we completed 108 enforcement cases (including the issuance of 19 disciplinary notices of decision) and commenced eight criminal and six civil proceedings.

Upcoming cases in courts and tribunals

Several trials and hearings arising from enforcement work of the Securities and Futures Commission (SFC) have been scheduled for the coming weeks. These cases deal with important issues, including allegations of false trading and disclosure of false or misleading information inducing transactions.

- A case regarding the alleged false trading of shares of Bauhaus International (Holdings) Ltd will be heard in the Eastern Magistracy on 22 April 2010.
- A trial regarding the alleged disclosure of false or misleading information inducing transactions in the shares of Vongroup Ltd will take place in the District Court on 26 April 2010.
- A verdict regarding the alleged false trading of derivative warrants issued by Macquarie Bank Ltd will be given by the District Court on 7 May 2010.
- A trial regarding the alleged false or misleading representations made in an application to the SFC will take place in the Eastern Magistracy on 10 May 2010.

Highlights

- From 1 December 2009 to 31 March 2010, the Securities and Futures Commission completed 108 enforcement cases (including the issuance of 19 disciplinary notices of decision) and commenced eight criminal and six civil proceedings.
- The SFC successfully obtained the eighth to 12th orders from the High Court to disqualify five company directors.
- For the first time, a listed company was directed to commence civil proceedings to seek compensation as a result of directors' misconduct.
- The SFC obtained an urgent injunction order to freeze IPO proceeds of up to \$997 million following a suspicion of false or misleading disclosure in the IPO prospectus.
- More than 25,000 investors of Lehman Brothers-related products recovered more than \$5.4 billion within 12 months.
- Licensees were disciplined following a Market Misconduct Tribunal determination.

- A pre-trial review regarding the alleged false trading of shares of Takson Holdings Ltd will take place in the Eastern Magistracy on 13 May 2010.
- A trial and a pre-trial review regarding the creation of an artificial price for dealings in the shares of IRICO Group Electronics Company Ltd by two defendants will take place in the Eastern Magistracy on 13 May 2010 and 8 July 2010 respectively.

For a complete list of upcoming prosecutions and related criminal hearings, please see “Upcoming Events and Calendar” on the SFC website.

Breakthrough in investor protection

From time to time, we report the disqualification orders obtained by the SFC against listed company directors under section 214 of the Securities and Futures Ordinance (SFO). Recently, the SFC obtained orders in the High Court to disqualify five company directors, being the eighth to 12th directors disqualified for misconduct.

These disqualification orders involved directors of two listed companies, namely, Warderly International Holdings Ltd (Warderly) and Rontex International Holdings Ltd (Rontex) (now known as Siberian Mining Group Company Ltd).

These disqualification orders denote a breakthrough in investor protection as this is the first time:

- directors were disqualified for failing to ensure timely disclosure of material information to the company’s shareholders (first in relation to the case of Warderly and then Rontex as the second case); and
- the SFC obtained an order in the High Court directing a listed company to commence civil proceedings to seek recovery of compensation for the loss and damage suffered by the company as a result of directors’ misconduct (in relation to the case of Rontex).

The SFC directed that trading in the shares of Warderly be suspended in May 2007 and focussed on the events between July 2006 and April 2007 in its investigation. The SFC alleged that Warderly should have disclosed its substantially depleted financial position to the market for the following reasons:

- Legal proceedings against the company and its subsidiaries by banks and creditors to recover overdue loans were in place.
- Warderly’s operations were substantially disrupted by labour strikes in its Mainland factory.
- The company had appointed a financial adviser in respect of a proposed debt restructuring and re-organisation.
- A management committee had been appointed to solve Warderly’s financial problems.
- An external firm of accountants had been appointed at the request of a bank loan syndicate and had reported on the company’s deteriorating financial position.
- The company was forced to raise money by way of loans at penalty interest rates to stay afloat.

The SFC sought to disqualify six current and former directors of Warderly in 2009 (see Issue No. 64 of the Enforcement Reporter). The recent orders were made to disqualify Ms Yeung Ying Fong Ellen and Mr Lai Wing Chuen John, from being directors or being involved in the management of any corporation for five years without approval of the court. They both accepted that they had breached their duties to Warderly by failing to manage the company with appropriate care. Also, they had failed to ensure that the company complied with the disclosure requirements under the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Ltd (SEHK).

In determining the length of the disqualification orders, the judge accepted the major concerns raised by the SFC:

- the failure to make disclosure related not to an isolated piece of price sensitive information, but a series of matters occurring within a short period of time; and
- the failure to make timely disclosure of price sensitive information resulted in the shareholders not being given any opportunity to dispose of their shares and minimise their losses, etc.

The SFC is taking similar action against four other former directors of Warderly.

The SFC commenced proceedings in relation to Rontex in 2008 (see Issue No. 60 of the Enforcement Reporter).

The court found that the directors had:

- breached their fiduciary duty and/or duty of care owed to Rontex;
- failed to ensure that shareholders received all the information concerning the company that they might reasonably expect; and
- failed to exercise reasonable skill, care and diligence in entering into a number of imprudent transactions on behalf of Rontex.

The breaches centred on four investments entered into by Rontex or its subsidiaries between 2002 and 2005, resulting in losses and damages of about \$19 million.

Orders were granted to:

- disqualify three former executive directors. Mr Cheung Keng Ching and Ms Chou Mei were disqualified from being a company director or being involved in the management of any company for five years, without approval of the court, except for their own private company. Mr Lau Ka Man Kevin, who consented to the orders, was disqualified for a period of four years;
- direct Rontex to commence legal proceedings against the three directors within 60 days to seek recovery of compensation as a result of their misconduct; and
- permit the company to use the SFC's evidence in bringing proceedings against the three directors, and require it to provide the SFC with a quarterly report on the progress of the proceedings.

The above cases illustrate that directors have an obligation to ensure that the company reports material information to the investing public on a timely basis. Failure to do so destroys transparency, trust and confidence in the market. More actions are in train to ensure that the investing public will not continue to invest their hard-earned savings in companies that are financially unhealthy.

As explained in Issue No. 60, in commencing proceedings to seek compensation orders, the SFC does not seek to make directors personally responsible for financial losses that are incurred in good faith. Rather, the SFC focuses on cases where alleged misconduct and bad faith by directors have led to the loss of shareholders' funds. There is no reason why shareholders should pay for losses caused by directors' misconduct.

The SFC has just been informed that two of the directors are appealing the length of their disqualifications and also appealing the directions given by the court in relation to the conduct of the proceedings to be commenced by Rontex.

For further information, please see press releases dated 25 September 2008, 16 September 2009, 17 March 2010 and 18 March 2010, judgment dated 18 March 2010 (HCMP 1869/2008) and reasons for decision dated 9 April 2010 (HCMP 1742/2009) on the [Judiciary's website](#).

Injunction order obtained to freeze IPO proceeds

In Issue No. 64, we reported the latest development in relation to the SFC's exercise of power under section 213 of the SFO. The SFC continues to make full use of its civil powers.

Recently, the SFC has obtained an urgent interim order from the High Court to freeze up to \$997 million in assets of Hontex International Holdings Company Ltd (Hontex) and four of its wholly owned subsidiaries. The amount of assets frozen represents the net proceeds raised by Hontex in an initial public offer (IPO) in December 2009.

Hontex is alleged to have disclosed materially false or misleading information and materially overstated its financial position in its IPO prospectus, which was likely to have induced investors to subscribe for its shares.

The SFC has identified approximately \$832 million held in bank accounts of Hontex and its four subsidiaries in Hong Kong. The SFC is continuing to identify more assets up to the value of \$997 million and to investigate concerns about the false or misleading disclosure by Hontex.

The interim injunction will remain in force until further order. This prevents the dissipation of assets pending the conclusion of the SFC's investigation and ensures that there are sufficient assets to satisfy any restoration or compensation orders.

If the SFC is successful in establishing its allegations, it will seek orders to restore the funds raised in the IPO to eligible investors.

The SFC had also issued a direction to SEHK to suspend trading in the shares of Hontex in order to maintain a fair and orderly market and to protect investors.

For further information, please see press release dated 8 April 2010.

Manipulators guilty of failing to answer SFC questions

In Issue No. 64, we reported a case in which four manipulators were jailed by the District Court for periods ranging from 26 months to 30 months. Two were also charged with the offence of failing to answer questions during the SFC investigation without reasonable excuse.

Section 183(1)(c) of the SFO requires a person under investigation or a person providing assistance to the SFC to answer any question relating to the matters under investigation that the investigator may raise. Any person who fails to give an answer "without reasonable excuse" commits an offence under section 184(1) of the SFO.

The two manipulators submitted that they relied on incorrect legal advice in refusing to answer questions raised by the investigator. A key issue was whether the reliance on legal advice constituted a "reasonable excuse." The prosecution submitted that a reasonable excuse is one that does not allow the person involved to defeat the legislative purpose, i.e., which does not allow the person relying on it to choose whether or not to comply with the relevant statutory duty.

On 9 February 2010, the court ruled in favour of the prosecution. The court stated that the offences were serious and that the objective of the legislation was to facilitate the SFC in carrying out its investigatory functions under the SFO.

The two manipulators, Mr Chan Chin Tat and Mr Chui Siu Fung, were found guilty of failing to answer questions during the SFC investigation, marking the first prosecution of its kind conducted in the District Court. Each was sentenced to a term of one-month imprisonment, to be served concurrently with their sentences for market manipulation.

For further information, please see press releases dated 1 November 2007, 10 July 2008, 7 August 2008, 13 November 2009, 26 November 2009 and 9 February 2010.

More than 25,000 investors recovered \$5.4 billion over Lehman Brothers-related products

The SFC has entered into agreements with 19 distributors of Lehman Brothers (LB) Minibonds (Minibonds) and a non-distributor, and helped more than 25,000 investors of LB-related products recover more than \$5.4 billion within 12 months.

Following the agreements reached with Sun Hung Kai Investment Services Ltd (Sun Hung Kai), KGI Asia Ltd and 16 distributing banks of Minibonds, the SFC reached an agreement with Grand Cathay Securities (Hong Kong) Ltd (Grand Cathay) in December 2009, bringing an end to the SFC's investigations into all 19 distributors of Minibonds. The agreement was reached after the SFC took into account that Grand Cathay had made repurchase offers voluntarily to all its 37 clients totalling US\$3.93 million.

In January 2010, the SFC reached an agreement with Karl Thomson Investment Consultants Ltd (Karl Thomson), a non-distributor that purchased Minibonds and resold them at \$2.57 million to 11 clients. Karl Thomson made repurchase offers voluntarily to all its customers on the same terms as the 16 distributing banks.

Under the agreements reached with the SFC pursuant to section 201 of the SFO, both Grand Cathay and Karl Thomson agreed to (among other things):

- immediately implement special enhanced complaints handling procedures to resolve all complaints in relation to the sale and distribution of structured products other than Minibonds;
- engage an independent reviewer to review their systems and processes relating to the sale of structured products, to report to the SFC and to commit to the implementation of all recommendations; and
- set aside \$712,423 and \$38,454 respectively, being commission income earned from the sale of Minibonds, to be paid to the Hong Kong Securities Institute to meet the costs of a series of seminars and/or training programmes on the subject of compliance with the Code of Conduct for Persons Licensed by or Registered with the SFC regarding the sale of investment products to retail investors.

Both Grand Cathay and Karl Thomson had fully co-operated with the SFC's investigations and taken the initiative to replicate the resolutions secured by the SFC with other Minibond distributors.

As for other structured products, the SFC and the Hong Kong Monetary Authority (HKMA) reached a resolution with Dah Sing Bank Ltd (Dah Sing) and Mevas Bank Ltd (Mevas) concerning their sale of certain Equity Index-linked Fixed Coupon Principal Protected Notes issued by LB. The two banks agreed to repurchase the notes from eligible customers at 80% of the principal amount invested.

As part of the agreement reached among the SFC, the HKMA and 16 distributing banks on 22 July 2009, the SFC required banks to adopt an enhanced complaints handling procedure to encourage banks to resolve complaints from customers who purchased structured investment products other than Minibonds. The recent repurchase offers made by Dah Sing and Mevas arose as a result of the enhanced complaints handling procedure. The SFC is pleased to see the procedure bringing positive results for customers.

By adopting a top-down investigation approach, the SFC has been able to resolve the largest number of complaints in the shortest period and, where it is appropriate, to ensure that the agreements reached provide reasonable remediation for customers and help restore investor confidence.

The SFC's investigations into the sale of other LB-related structured products are continuing.

For further details, please see press releases dated 22 January 2009, 5 April 2009, 2 July 2009, 22 July 2009, 17 December 2009, 23 December 2009 and 13 January 2010.

Action against manipulative conduct continues

The SFC continues to take appropriate action against misconduct that is harmful to the market and the investing public.

Action taken following Market Misconduct Tribunal's determination

We reported in Issue No. 62 that the Market Misconduct Tribunal (MMT) determined four persons were culpable of market misconduct in relation to dealing in the shares of QPL International Holdings Ltd.

The MMT found that:

- Mr Chau Chin Hung (Chau), acting as a director and responsible officer of Sun Hung Kai, had engaged in false trading and price rigging by placing a significant number of bid orders over a period of five weeks. The bid orders were never executed, and were generally immediately cancelled, reduced in size, cancelled later on the same day and re-issued at the same price shortly thereafter;
- Ms Cheung Sau Lin Connie (Cheung), acting as an employee or agent of Sun Hung Kai, had assisted Chau to engage in the market misconduct; and
- Sun Hung Kai was vicariously liable for the misconduct of Cheung, and that the misconduct of Chau was attributable to Sun Hung Kai due to his capacity, etc.

The MMT ordered, among other things, that the SFC be recommended to take disciplinary actions against Chau, Cheung and Sun Hung Kai, because persons licensed with the SFC had been found culpable of market misconduct.

Following the MMT's determination, the SFC:

- publicly reprimanded Chau, fined him \$2 million and prohibited him for life from re-entering the industry. The SFC took into account that he abused his senior position at Sun Hung Kai by procuring the assistance of Cheung to conduct unlawful activities;
- suspended the licence of Cheung for three years; and
- publicly reprimanded Sun Hung Kai and fined it \$4 million for internal control failures. Although Sun Hung Kai had policies to segregate proprietary trading from client trading, Chau was given authority to conduct both types of trading. Thus Chau could place the bid orders through the account of an associated company of Sun Hung Kai.

For further information, please see the MMT's reports dated 22 January 2009 and 25 February 2009, and press releases dated 12 October 2009, 17 December 2009 and 28 January 2010.

Licensee disciplined for failing to recognise suspicious trades

In a disciplinary case, Ms Keung Yat Fai Janice was suspended by the SFC for 10 weeks for merely acting as a middleman in passing a client's orders for execution and failing to take reasonable steps to ensure that her client's trading activities were genuine and were not abusing market integrity.

The client was given a two-month jail sentence (suspended for 12 months) following her guilty plea to manipulating two derivative warrants during three closing auction sessions.

Keung's failures had apparently put her employer at risk of being used as a means for illegal misconduct.

For further details, please see press releases dated 27 August 2009 and 21 December 2009.

Arrest warrant issued for suspected manipulator

Recently, the SFC commenced criminal proceedings against three persons in relation to allegations of market manipulation under section 295 of the SFO and fraud under section 300 of the SFO.

The SFC alleged that between 1 and 3 April 2008:

- the three defendants manipulated the shares of IRICO Group Electronics Company Ltd (IRICO); and
- one of the defendants also defrauded two unauthorised investment funds by acquiring the shares of IRICO and Catic International Holdings Ltd (Catic) on behalf of the funds, which he managed at that time. The share price of IRICO had been inflated following the alleged manipulation and the shares of IRICO and Catic allegedly were owned also by that defendant.

The transactions executed on behalf of the funds might have been contrary to the interests of investors.

On 4 February 2010, the defendant who had allegedly defrauded the funds did not appear at the Eastern Magistracy and might have left Hong Kong. Upon the SFC's application, the Eastern Magistracy issued an arrest warrant. The other two defendants pleaded not guilty.

For further details, please see press release dated 4 February 2010.

Stay vigilant ...

Recent events show that one should stay vigilant to prevent themselves from facilitating illegal activities.

Licensee let boiler room share office premises

The SFC found that Fukoku Investment (Asia) Ltd (Fukoku), a licensed corporation, had failed to detect and stop Peninsula Capital Ltd (PCL), an unlicensed entity, from operating what appeared to be boiler room activities at its office premises, and provided it with administrative support between April and October 2008. In return, Fukoku received "finder's fees" totalling \$152,035 from three US companies backing PCL. Mr Wong Kin Man Anthony (Wong), Fukoku's responsible officer, agreed to let PCL's staff operate from Fukoku's office premises.

Following an investigation, the SFC:

- reprimanded Fukoku and fined it \$2 million; and
- revoked the approval granted to Wong to act as a responsible officer and suspended his licence for two years.

PCL's operations resembled a boiler room scam in that it:

- set up an office in Hong Kong that targeted overseas investors;

- promoted on the internet three over-the-counter US stocks, which were thinly traded and had a value close to zero; and
- used Fukoku as a front to give its operations a semblance of legitimacy.

PCL has ceased operations in Hong Kong and its operators have disappeared. On 17 March 2009, the SFC added PCL to its Alert List and warned investors of a possible scam.

Boiler room scams are international scandals and they can damage Hong Kong's reputation as an international financial centre. The SFC's actions show that there is no place for this kind of misconduct.

For further information, please see press release dated 25 February 2010.

Person convicted of dealing in proceeds of crimes

Mr Jerome Herzberg was convicted of dealing with proceeds of an indictable offence, contrary to section 52(1) of the Organized and Serious Crimes Ordinance (Cap. 455). Following an application for review, the sentence of the District Court was quashed by the High Court and was increased to an imprisonment term of five years and six months.

Investors, who were based in England, were induced to purchase shares and then transfer monies into bank accounts in Hong Kong. None of the companies selling the shares in England were registered with the Financial Services Authority (FSA) of the United Kingdom to market or sell shares. The shares were those in companies in the US but, unknown to the investors, subject to significant restrictions in respect of resale.

The bank accounts in Hong Kong were opened and operated by Mr Herzberg.

One of the bank accounts was suspended following a customer's complaint. Mr Herzberg was informed by the bank that there had been claims of fraud made against the corporate entity selling the shares and that an investor alert had been issued by the FSA and the SFC. Mr Herzberg agreed to repay monies paid into the account by the complainant.

Notwithstanding those circumstances, not only did Mr Herzberg continue to operate the other bank accounts but also opened a new account.

In applying for the review, the Department of Justice (among other things) submitted that the District Court failed to take into account as an aggravating factor that Mr Herzberg knew the monies deposited into the accounts he opened were possibly proceeds of serious crimes after being informed by the bank of complaints of fraud against the unlicensed company and that investor alerts had been issued by the regulatory authorities.

Prior to the warning, \$683 million had been remitted to the bank accounts opened by Mr Herzberg over a period of 21 months. Following the warning, no less than \$228 million had been deposited into the accounts in about eight months.

In reviewing the sentence, the High Court held that, *"Given the scale and duration of [Mr Herzberg's] misconduct . . . , the resolute nature with which he continued to receive and return remittances in the face of specific clear warnings as to the underlying nature of the remittances and the obvious jeopardy ensuing to the reputation for integrity of the Hong Kong financial system, it is clear that a deterrent sentence was required."*

In dealing with funds, people should watch out for warning signs (e.g. investor alerts issued by regulatory authorities including the SFC) and make pointed enquiries of their clients (e.g. regarding the source of funds). Those who have been put on notice that funds are possible proceeds of crime, say because an alert has been issued by a regulator, should refuse to deal with them, thus avoiding taking part in any laundering process.

For further information, please refer to the judgment of the Secretary for Justice vs Jerome Yuval Arnold Herzberg dated 14 December 2009 (CAAR8/2008) on the [Judiciary's website](#).

Enforcement policy and practice

Built-in price check to preserve market integrity

In Issue No. 60, we discussed algorithmic trading. While acknowledging that algorithmic trading systems play a legitimate role in executing trades and freeing dealers to concentrate on more judgment-intensive work, we also reminded licensees that a lack of human supervision of algorithmic trading systems can pose compliance problems and recommended that they monitor algorithmic trading.

Recently, an SFC inquiry revealed that some bid orders were executed at exceptionally high prices at around market close, thereby resulting in a sharp increase in the closing price.

The bid prices had indeed been revised automatically by an algorithmic trading system to ensure completion of a bulk order, which was divided into sub-orders for execution. The dealer who selected the trading strategy did not realise that the algorithmic trading system had no built-in price limit control mechanism on sub-orders due to a development oversight. Therefore, the revised bid prices were not subject to an algorithmic price check and the bid orders were executed at exceptionally high prices.

Licensees are reminded to establish, maintain and enforce comprehensive policies governing the implementation of algorithmic trading systems, including monitoring and detecting any irregular orders placed by such systems, to preserve the integrity of the market.

Disclosure of interests

Failure to disclose interests prosecuted

The SFC continues to attach importance to the obligation of 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 their company and SEHK of changes in their interests.

From 1 December 2009 to 31 March 2010, the SFC prosecuted three entities for breaches in disclosure of interests and all defendants pleaded guilty. Fines ranging from \$ 6,000 to \$ 8,000 were imposed.

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.

If you want to receive the Enforcement Reporter by email, simply register for the Update Email Alert service at <http://www.sfc.hk> and select Enforcement Reporter. Intermediaries licensed by the SFC receive the Enforcement Reporter via their FinNet email accounts.

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