

## Investment Products and Regulatory Forum

**Mark Steward**  
**Executive Director of Enforcement**  
**Securities and Futures Commission**

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### Opening

Thank you to Deacons for inviting me to speak to you this afternoon.

I have been asked to address a number of different aspects of our enforcement work including recent work and cases, our priorities and focus, section 201 resolutions, our surveillance techniques and finally, some issues relating to inside information.

Let me start with the current state of play in our work. The most critical challenge, at least from my perspective, is its volume.

### Recent and Current Work

Since 2007 there has been an increase in the number of investigations we have commenced and completed in our key areas of interest. Using a simple year against year comparison between 2007 and last year:

- insider dealing investigations have increased by more than 250%;
- market manipulation investigations have increased by 240%;
- corporate governance cases have increased by 530%; and
- intermediary misconduct cases have climbed by 280%.

The consequence of so many cases is that there has also been an increase in the number of cases before Hong Kong's courts and tribunals as well as a change in the nature, complexity and seriousness of these cases.

The most significant increase is in the amount of civil litigation, especially before the High Court where, again comparing the position five years ago with the most recently completed year, there has been an increase in activity of over 450%.

Using insider dealing cases as yardstick, in the same period (i.e. from March 2007 to now) we have taken action against 43 people for insider dealing:

- leading to 32 criminal convictions against 12 defendants,
- the Market Misconduct Tribunal (MMT) has made findings that a further eight defendants have contravened the insider dealing prohibition with consequential orders being made against them; and
- we have commenced civil proceedings against a further 22 defendants alleging insider dealing, all of which remain pending in the High Court.



In addition to these pending civil cases, we are awaiting the start of another insider dealing criminal trial in August relating to trading in the shares of CITIC Pacific before it announced its foreign exchange losses in 2008 and the MMT has just commenced two hearings, one concerning allegations of manipulation of the shares of Yue Da Mining Holdings Ltd and, the second, concerning allegations of insider dealing in the shares of China Huiyuan Juice Group Limited before the takeover announcement made by Coca-Cola (subsequently aborted).

### **Current Focus**

Let me turn to our current focus. Our strategy is to maintain active programs in five key areas all of which give rise to regulatory concern and loss or damage for the investing public. See **Figure A**. (I have taken out two other programs that take up considerable resources, our international work and our ongoing Part XV (Disclosure of Interests) summary prosecution program. Both are important. For example, our ongoing international work is more or less 10% of our current workload).

The function of this strategy is, in effect, to ensure we do not overly concentrate resources and attention in only one area leaving ourselves and the market exposed to greater risk of misconduct in another area. In short, the risk of being active in one area, like insider dealing, is that other important areas may be neglected.

Our mooncake of five key programs is intended to cover our key regulatory responsibilities where the investing public is most vulnerable to misconduct. The mooncake helps us to monitor our rate of productivity in each program; to become more efficient and also more outcome-focused; to measure our allocation of resources against each program; to maintain a broadly proportionate and equal commitment in each of these areas and to insure against the risk that success in one segment is not at the risk of inactivity in one of the other important programs.

As you can see, under this approach, insider dealing and market manipulation combined ought to be no more than 40% of our overall commitment.

By and large, we have maintained a rate of activity in each of these programs, as exemplified by:

- the recent High Court decision in Styland Holdings Ltd involving the first orders against listed company directors to compensate shareholders for breaches of duty and other misconduct causing loss of shareholders' funds;
- the revocation of Mega Capital's sponsor licence over the Hontex IPO (which we are litigating at the moment in the High Court) and the imposition of \$42 million in fines; and
- the action taken against Billion Dollar Global Asset Fund, an unlicensed fund manager promising excessive returns to investors and which was a scam.

Broadly speaking, this strategy has worked. But at the same time there always seems to be a reason for resources to be skewed in one direction more than another. The most recent snapshot demonstrates this. See **Figure B**.

The current snapshot is unusual because of the comparatively small percentage of current cases dealing with unlicensed dealing by comparison with the larger percentage of cases dealing with intermediary misconduct.



On an historical basis going back over the last five years, this snapshot is atypical and raises the risk that we will miss something important in the unlicensed dealing space.

### **Detection and Surveillance**

The reason for the increase in activity is, I think, a consequence of our approach to enforcement. We do not receive many complaints or tip offs. Most of our enforcement work arises from detection by our surveillance programs. It is self-generated.

Our surveillance systems detect about 100 red flags on a daily basis and each of these is the subject of personal attention. Either we find an explanation for the red flag virtually straight away or we don't. In the latter case, more inquiries need to be made.

I have been asked to provide some insight into how our surveillance systems actually operate and, for obvious reasons, that is not possible. By the same token, I do not think we have any magical formula for detecting potential problems.

The upshot is that our surveillance systems cast a very wide dragnet over the market which means we have a high volume of inputs into our decision-making systems.

We probably commence more investigations than most law enforcement agencies because we consider that it is too risky, in many instances, to make good resourcing decisions too early before any digging has had a chance to come up with any concrete or more objective information.

Well over 50% of investigations we start ends up being written off which is probably the opposite of what occurs in many other agencies. In many agencies, this would be viewed as a measure of inefficiency. It is the opposite for us. A high write-off rate is a necessary consequence of tackling forensically difficult market fraud in often highly ambiguous conditions.

The other important part of this discipline is that we target completion of 70% of all investigations within seven months of commencement. I have been asked to talk about whether we meet this target. We measure our performance against this target on a monthly basis and, in fact, have exceeded it in most occasions but it is has been very hard to meet over the last 12 months. We are currently meeting it but only by the narrowest of margins.

I think there are three main reasons for this.

First, so many more of our cases are now tied up in long-running and complex litigation, all of which needs to be resourced.

The second reason is the degree to which we can identify more efficiency under our current resourcing model may well have reached its natural limit given the substantial, if not exponential increase in our workload as against the increase in our headcount.

The third reason is that there is a growing backlog of market misconduct cases with the Director of Prosecutions (DPP). There are currently 15 cases in this category, nine of which have been there for more than seven months. I suspect DPP is similarly inundated with more complex work.



## **Section 201**

Let me now move on to agreed resolutions under section 201 which I have also been asked to talk about.

As many of you will know, when we are bringing disciplinary proceedings against a person, we have a statutory power to enter into an agreement, where it is in the public interest to do so, to resolve those proceedings rather than pursue them through the formal process.

We issued guidance many years ago to the effect that in return for cooperation we are prepared to reduce the level of sanction by one third.

I have been asked whether this remains our policy. It does remain firmly in place. And in a large number of cases we have gone further.

We are prepared to commute financial penalties in exchange for agreements to remediate any person who has suffered loss or damage as a result of the conduct that has been complained about. We have done this frequently in recent years, especially since 2008, where there has been loss or damage to members of the investing public. In effect, we will frequently regard these solutions as an appropriate expiation of misconduct.

Of course these solutions are usually accompanied by other measures as well. But the message is that the financial penalty is something that is commutable in return for an agreed framework to make good the damage that may have been caused. Our remediation programs are stringent and they are closely monitored and supervised. They usually have to be completed within a time period and sometimes, where there are disputes about quantum, additional independent assessments need to be made. They are not a necessarily easy way out. But they are sensible and practical.

This was the whole rationale of our approach in tackling the Minibond and structured product investigations where the section 201 resolutions have led to \$8.8 billion in repurchases in favour of more than 35,000 retail investors together with a further \$995 million in compensation under the enhanced complaints handling process as well as the use of the banks' commission revenue from the sale of these products to fund the trustee's action to secure the return of the collateral. The latter has proven very successful. The last collateral return agreement (for Minibond series 5-9, the most under water of all Minibond series) was finally secured by the receivers and announced last Monday. The vast majority of retail investors have received back between 85% and 96.5% of their initial investment.

No penal sanction was imposed on any of the banks involved in this process given the very substantial remediation that they agreed to put in place.

This was undoubtedly the right response and shows that the resolution mechanism is one that can secure tangible benefits for all those affected by wrongdoing.

## **Recent Market Misconduct Cases**

I have been asked to talk about some recent cases, notably the Market Misconduct Tribunal's decision in the case of trading in shares of Chaoda Modern Agriculture Holdings Ltd.

In this case, Chaoda was looking to raise capital by way of a placement to six US based investors. The placement was scheduled to proceed some time earlier but was postponed. It



was then put back on track. Merrill Lynch, on behalf of Chaoda, arranged for the company to speak to the six investors in the United States by conference call.

The case focused on one fund manager, Fidelity's George Stairs, who sold Chaoda shares after the conference call before the stock was suspended for the placement announcement. He also directed the relevant Fidelity funds to participate in the placement.

There was evidence that Stairs was told in the conference call that Chaoda had decided to proceed with the placement to the value of \$220-250 million at \$5.00 per share. Stairs made a note that the placement was to be at a discount of 12% of the then market price. In the end, it took place at a slightly different price but nonetheless at a discount to the last traded price and the average price over the last ten trading days.

Stairs gave evidence to the MMT that he believed the placement would occur in the coming weeks and not immediately. However, there was evidence from another prospective investor who was similarly called that evening that it was clear the offering was imminent and would take place the next day. This is exactly what happened.

The MMT found that Stairs understated his awareness of the timing of the placement and knew the placement was imminent rather than in the coming weeks.

The MMT was satisfied Stairs was told about the fact of the decision to proceed with the placement, its size and price and that all of these matters meant it was likely the placement would have a diluting effect and would result in a lower share price.

Stairs placed a sell order within the first hour of trading in Hong Kong on the following day. He was at home at the time in the United States. He said his decision was based on a desire to trim his holdings. The MMT found it was no coincidence that he did so on the very same day he learned about Chaoda's proposed placement and that he did so to avoid the loss on these shares that would be incurred once the dilution effect of the placement was factored into the price.

One unusual factor in the case was that there was evidence that Merrill Lynch, who were Chaoda's advisers, were well aware of Fidelity's normal requirements for wall-crossing but they did not trigger them. In effect Stairs and his Fidelity colleagues entered the conference call without any of the usual protocols being observed and so, it might be thought, were not prepared to receive any inside information from the company.

The MMT was critical of Merrill Lynch for not following the obvious protocols and conceded this had made Stairs vulnerable to the receipt of inside information without prior warning or agreement. But this could not be a defence.

Experienced fund managers are well placed to assess the value or price effect of information they receive, especially from a company they follow closely. They should not need the equivalent of traffic cones around inside information nor the assistance of the proverbial lollipop man at the school crossing to negotiate discussions with senior management of listed companies. In any event, wall crossing protocols protect the person providing the information from potential liability in tipping rather than the person receiving the information.

This case is a caution for anyone who receives briefings from corporates as part of their job pursuant to a formal wall-crossing process, a sounding out or pre-sounding out.



## **Receipt of Inside Information**

This brings me to the last issue I have been asked to address which is what do you do if you have been given inside information in a conference call or as a result of a briefing and you would like to trade.

Clearly, the Stairs case should tell you this would not be a good move.

Nonetheless, what, if anything should you do?

This is far from being an academic question.

The issue is an important one and highly topical because of the recent changes to the law in Hong Kong creating statutory obligations for listed companies to disclose inside information to the market as soon as practicable.

If it happens that a listed company discloses inside information in a briefing it is fundamental that this information be disclosed to the market as soon as practicable before trading

Anyone in receipt of inside information is precluded from trading until that occurs.

The only option is to refrain from trading or to take the matter up with the company to see how soon an announcement can be made. If the company declines to make an announcement either as soon as practicable, or at all, the matter should be referred to us. Not in an enforcement sense, at least initially, but for the purpose of engaging the company to determine whether there is a legitimate basis for not disclosing the information straight away or not.

It is in the interests of the market for listed companies to raise their game not only to ensure information is disclosed without delay but also to prevent leakage and selective disclosure, either intentionally or negligently.

Both measures will reduce the opportunity for insider dealing which should also reduce its incidence and this must be in all our interests.

I have run well over time. Thank you for listening to me.



**Figure A**





**Figure B**

