

A regular communication about the SFC's enforcement work

Welcome to the new series

In December 2016, the Securities and Futures Commission (SFC) relaunched its *Enforcement Reporter* as a biannual newsletter to provide the market with regular updates on our current enforcement work and priorities.

Each issue of the *Enforcement Reporter* will highlight specific issues that are the focus of our enforcement efforts. We hope that you find the newsletter useful.

Highlights

- Liabilities of directors and senior executives of listed companies
- Senior management accountability
- Lessons from recent cases
- Valuations in corporate transactions

Liabilities of directors and senior executives of listed companies

Corporate fraud and misfeasance

Our top enforcement priorities are corporate fraud and misfeasance. These pose the number one risk to Hong Kong's markets and investors.

Our financial markets are recognised internationally as fair, open and transparent, but recurring incidents of fraud and misconduct involving listed companies threaten to blemish this reputation. Despite stronger enforcement efforts, there have been disturbing cases involving corporate fraud, misleading financial statements, serious conflict of interests and failure to disclose inside information.

We are conducting a large number of investigations into such cases. Many involve serious allegations and dereliction of duty on the part of directors and senior executives. If all these allegations are proven, we are looking at potentially very significant investor losses.

The key issues in these cases include:

- outright fraud by powerful directors or senior executives who are usually company controllers;
- company controllers putting their own interests before those of the company and its minority shareholders without understanding that the company is an independent entity with its own interests;
- other directors or senior executives deferring to a dominant company controller by relinquishing their responsibilities or accepting compromised roles which prevent them from properly discharging their own duties;
- non-executive directors (NEDs) not acting as a check and balance on executive directors and failing to be skeptical and diligent in discharging their duties and to thoroughly question whether proposals are commercially sound and in the interests of all shareholders; and
- boards and senior executives not having proper controls to ensure that the board is aware of inside information and to disclose it appropriately as soon as reasonably practicable.

“Heavy is the head that wears the crown”¹

The crucial role of company directors and senior executives

Company directors and senior executives owe very important and serious duties to the company and its shareholders. Therefore, they have a key interest not only in ensuring that the company is profitable and well-run, but also in caring for minority as well as majority shareholders.

The job is complex and getting more so. Directors and senior executives must be inquisitive, professional and diligent to do their jobs properly and with integrity. Otherwise, they run a real risk of shareholder suits, regulatory investigations or even enforcement action.

“Corporate fraud and misconduct are our top enforcement priorities.”

No matter how complicated the situation, remembering some basic rules and the key nature of directors’ duties should ensure that they safeguard their company and shareholders and avoid unwanted regulatory attention.

Although independent non-executive directors do not take part in the daily management of companies, they serve a very important role in supervising management and protecting shareholders’ interests. When they have disagreements with the board or believe that the interests of shareholders are oppressed, they should openly communicate their views to all shareholders and, if they choose to resign, provide substantive reasons for their resignations.



We remind company directors and officers that they have duties to:

- act in good faith and in the best interests of the company and its shareholders as a whole
- exercise due and reasonable care, skill and diligence
- exercise independent judgement
- exercise their powers for proper purposes
- avoid actual or potential conflicts of interest
- refrain from making undisclosed profits

We also expect directors and senior executives to use their powers to implement proper internal controls and foster a culture of good corporate governance to reduce the incidence of fraud and misconduct in our markets. If left unchecked, fraud and misconduct may erode global investors’ confidence in our markets, inflicting lasting damage on our reputation as an international financial centre.

Directors and senior officers who fail to perform their duties can expect tough enforcement action if the company or its minority shareholders are materially harmed as a result.

¹ William Shakespeare, *Henry IV, Part 2*.

Above and beyond – An interview with Dr Kelvin Wong

Dr Kelvin Wong is a Non-Executive Director of the SFC, the immediate past Council Chairman of the Hong Kong Institute of Directors and a veteran of listed company boards. He shared his views on what directors and senior executives can do to guard against corporate misconduct.

There are a number of steps directors and senior executives can take to protect their companies and shareholders from corporate misconduct and to foster a culture of good corporate governance.

A key step is to make sure effective internal controls and whistleblowing policies are in place and to establish a company-wide culture of checks and balances to enforce rules and policies which cannot be overridden by anyone. Ensuring the integrity of the company's financial statements and assets and regularly reviewing the effectiveness of internal control systems are equally important to guard against fraud, Dr Wong added.

For directors in particular, it is essential that they take the lead to discuss governance-related matters on a regular basis. In Dr Wong's experience, speaking informally with senior management about issues facing the company provides an opportunity to offer suggestions and raise concerns more freely.

Taking a genuine interest in the company's affairs by getting regular updates on management accounts and corporate performance and attending board meetings will help identify issues which need attention. And it is important that directors and senior management abstain from discussing or being involved where they may have a conflict of interest.



One big challenge, Dr Wong stressed, is that many governance issues are not well defined, while laws and rules are only minimum requirements. Recent SFC enforcement actions targeted directors and senior executives at a number of listed companies. Even though most of these companies had experienced management teams and seasoned board members in place, their established corporate governance policies were not sufficient to prevent the problems which led to regulatory sanction.

These examples show the importance of establishing a strong corporate governance culture and encouraging good practices which go above and beyond what is required in the letter of the law. And at the end of the day, promoting effective management processes not only helps avoid corporate misconduct, it should also enhance corporate performance, Dr Wong concluded.

Senior management accountability

We will continue to use all our enforcement powers available to us under the Securities and Futures Ordinance (SFO) to ensure that directors and senior executives are held accountable for their actions.

This is one of the most effective ways to change corporate behaviour and dissuade future misconduct.

As part of our new enforcement approach, we formed specialised teams to help us work as efficiently and effectively as possible and to deliver enforcement outcomes when they are still relevant.

The key priorities for our investigations and enforcement actions are:

- fraud
- misleading financial statements
- serious conflict of interests

Our powers under the SFO include:

- **Section 213:** We may seek injunctive and other orders for restitution or damages against anyone, including a director or senior officer, who has contravened, or aided, abetted, induced or been involved in a contravention of, any provision of the SFO.
- **Section 214:** We may take action and obtain court orders for breaches by current and former directors and executives which resulted in losses to listed companies. For example, we may seek disqualification orders for up to 15 years as well as orders that the relevant directors pay compensation or that the listed company bring legal proceedings against anyone responsible for carrying out the affairs of the company in an unfair, fraudulent or other manner specified in section 214.
- **Sections 258 and 307N:** We may seek civil sanctions directly against any officer who failed to take reasonable measures to establish proper safeguards to prevent market misconduct, even if the officer did not personally engage in the misconduct. For example, we may seek disqualification and other orders against the directors and others involved in the management of a company

where market misconduct is directly attributable to their failure to ensure the implementation of proper safeguards.

- **Section 390:** Where a company has been found guilty of an offence under the SFO, we may seek to extend criminal liability to any of its officers where the offence was committed with their consent, involvement or otherwise attributable to their recklessness. Officers who committed offences such as disclosing false or misleading information likely to induce others to deal in securities or using deceptive or fraudulent conduct, devices or schemes with the intention to defraud are liable to a maximum of 10 years' imprisonment and a fine of up to \$10 million.





Lessons from recent cases

Directors and senior officers play an important role in listed companies' performance and in protecting the interests of all of their shareholders.

Fraud and misleading financial statements

Company directors and senior executives must not accept arrangements which would unreasonably interfere with the proper discharge of their duties. While they can delegate, they must also be able to supervise, review and, if necessary, challenge the work of their delegates. In particular, they must not defer to dominant controlling shareholders or relinquish or compromise their responsibilities. If they cannot properly perform their duties, they should resign and insist that honest reasons are given for their resignation in a company announcement.

Greencool Technology Holdings Limited

This is one particularly serious recent case of fraud and misleading financial statements before the Market Misconduct Tribunal (MMT). The Chairman, who is also the Chief Executive Officer and ultimate controlling shareholder, allowed the company's net assets to be grossly inflated in its annual accounts by a total of 80%, representing RMB904 million, over several years.

In addition, the company's Mainland subsidiaries provided false accounts to the group's auditors. Greencool's senior executives either knew of the fraud or were reckless or negligent as to whether the accounts were false or misleading. The MMT agreed with our allegations and found some of them culpable of market misconduct.

In this case, we pursued company executives who enabled the fraud by failing to discharge their duties. The group financial controller and company secretary, who was also the "qualified accountant", accepted an arrangement limiting his access to the Mainland subsidiaries' accounts and financial reporting systems. The MMT found that his acceptance of this irrational arrangement suggested he knew that the executive directors deliberately limited his ability to fulfil his duties. As a result, he was negligent as to whether the audited accounts were false or misleading.

To compensate victims, we commenced parallel court proceedings under section 213 of the SFO to seek compensation for more than 1,300 minority shareholders and obtained an injunction to freeze assets worth up to \$1.2 billion.

China Metal Recycling (Holdings) Limited

This case marked the first time we obtained a court order to wind up a Hong Kong-listed company under section 212 of the SFO to protect minority shareholders, creditors and investors.

A sophisticated fraud spanning Hong Kong, Macau, the Mainland and the United States grew larger and more complex, inflating the company's revenue and profit from the initial public offering track record period until 2013 when we commenced legal proceedings. The scheme involved fake scrap metal shipments between the US and the Mainland, associated false shipping documents and circular flows of funds between customers and suppliers to create illusory profits.

The Hong Kong Police also charged a board member and a staff member of China Metal Recycling with one count of conspiracy to defraud.



Serious conflicts of interest

Directors and senior executives must always put the company's interests before their own and look after the interests of all of the company's shareholders. They should be careful not to put themselves in a position where their personal interests conflict with those of the company.

If a conflict cannot be avoided, they should ensure that the company is fully informed and avoid playing any decision-making role in relation to the possible conflict. Directors and senior executives not involved in a conflict, but aware of one, should take reasonable steps to carefully scrutinise the conflict and ensure that the company is fully informed and its interests as a whole are properly protected.

“Directors and senior officers play an important role in protecting the interests of all shareholders. Those who fail to perform these critical duties will be held accountable.”

Hanergy Thin Film Power Group Limited

We recently commenced proceedings under section 214 of the SFO to disqualify five directors of Hanergy Thin Film Power Group Limited. We alleged that they failed to act in the company's best interests as they did not question the viability of Hanergy's business model, which relied heavily on sales to its parent company and affiliates as the main source of revenue.

Moreover, we also alleged that the directors did not assess the recoverability of receivables owed by the connected parties and, when issues arose, the directors allegedly did not take proper steps to recover them, putting the interests of the connected parties before those of Hanergy. We are seeking a court order requiring the controlling shareholder to guarantee the settlement of the outstanding receivables.

Freeman FinTech Corporation Limited

We commenced legal proceedings under section 214 of the SFO to disqualify 10 former executives and NEDs of Freeman FinTech Corporation Limited. We alleged that they failed to act in good faith and in the best interests of Freeman in the purchase and sale of a stake in Liu's Holdings Limited. Freeman eventually had to sell the shares, resulting in a \$76.8 million loss.

We are also seeking a compensation order under section 214 against the managing director and a particular NED to hold them accountable for the harm they caused the company. We alleged that they caused Freeman to enter into a purchase that could not be completed due to the objection of Liu's Holdings Limited's shareholders who held pre-emptive rights² over the stake.

In addition, the NED allegedly failed to disclose these objections to Freeman and its shareholders. In our view, this failure and his related actions were motivated by self-interest and were not in the interest of the company.

Failure to disclose or late disclosure of inside information

Directors and senior executives must ensure that their company has reasonable measures to ensure the disclosure of inside information as soon as reasonably practicable upon coming to know of it.

Recently, we successfully took actions against the directors and senior executives of Yorkey Optical International (Cayman) Limited, AcrossAsia Limited and Mayer Holdings Limited for late disclosure of inside information at the MMT. These were our first cases under Part XIVA³ of the SFO for breach of corporate disclosure obligations. The MMT imposed sanctions against individual directors and senior executives, including fines of up to \$1 million each and disqualification orders.

These decisions demonstrate that both we and the MMT take late disclosures very seriously and are prepared to hold directors personally liable.

² Rights to purchase shares before they are offered to others.

³ This sets out the statutory regime for listed companies' disclosure of inside information which came into effect on 1 January 2013.



Valuations in corporate transactions

We recently issued guidance for listed company directors and senior executives on their duties in relation to valuations in corporate transactions. Specifically, they have the duty to responsibly determine whether the terms of a transaction, including the consideration, are fair and reasonable. Failure to do so would be considered an abrogation of their duties to the company. Directors cannot abdicate their responsibilities by using valuers as a shield.

If directors and senior executives do not follow the guidance, it is likely that we will investigate and possibly take action under section 214 to seek disqualification, compensation and other orders against them.

We advise directors and senior executives to read and consider the guidance carefully.

Where to seek help and advice

For more information and training on your duties as a company director or senior officer and on appropriate corporate governance procedures, you can contact:

- The Hong Kong Institute of Directors: www.hkiod.com/training.html
- The Hong Kong Institute of Chartered Secretaries: www.hkics.org.hk

If you want to receive the *Enforcement Reporter* by email, simply subscribe at the SFC website at www.sfc.hk and select *Enforcement Reporter*.

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