A Sign of Things to Come: Securities and Futures Trends Analysis

Greater Corporate and Individual Accountability for Regulatory Compliance in the Hong Kong Securities and Futures Market

June 2015

Dechert LLP

Table of Contents

A Sign of Things to Come:
Securities and Futures Trends Analysis

Greater Corporate and Individual Accountability for Regulatory Compliance in the Hong Kong Securities and Futures Market

Introduction

2008 marked the height of the global financial crisis. The intervening years have seen criticism of financial regulators, a variety of enforcement activities and a raft of regulatory reforms. Hong Kong and its Securities and Futures Commission (SFC) are generally considered to have fared well in their response to the financial crisis. Five years on, we have analysed regulatory and enforcement developments in Hong Kong between 2009 and 2014,[1] and considered where the SFC may direct its future regulatory oversight and enforcement activities.

In this, the first of our series of reports, we present an overview of the SFC's supervisory and enforcement activities over the review period, before considering in more detail the regulatory and enforcement developments pertaining to intermediary misconduct and unlicensed activities – two of the SFC's core enforcement programmes. Studies of pivotal cases are presented, highlighting lessons learnt and practical tips for the future. Subsequent reports will focus on the SFC's other core enforcement programmes: corporate governance and disclosure, insider dealing and market manipulation.

[1] This report relies, in part, on the SFC's annual and quarterly reports issued from 1 April 2009 to 30 September 2014, for statistics that only the SFC can provide (e.g., number of investigations commenced, enquiries made, and breaches noted in inspections). To provide further insight, we compiled additional data by collating and analysing the SFC's enforcement news from 2009 to 2014, and analysed selected key cases during this period, reviewing the SFC's and other regulators' press releases, court and tribunal judgments, market releases and other publicly available information.

Overview of SFC Supervisory and Enforcement Activities

It will come as little surprise that there has been increased regulatory activity, as well as enforcement actions, across all five of the SFC's core enforcement programmes.

Focusing on conduct primarily affecting Hong Kong's regulatory market, the SFC has sought, through its supervisory activities and enforcement actions, to hold corporations and individuals – particularly senior management – accountable for regulatory failings. For example, directors who have been guilty of misconduct have been the subject of civil proceedings and director disqualification orders, while responsible officers (ROs) who have failed to discharge their oversight duties have been sanctioned for the failings of their licensed corporations and/or the corporation's staff.

In doing so, the SFC has made very good use of its extensive powers under the Securities and Futures Ordinance (Cap. 571) (SFO),[2] adopting a penal as well as a restorative approach. The SFC has been aggressive, as evidenced by the increased use of search warrants, notwithstanding its already extensive powers under s.182 and 183 to obtain information. It has also been innovative (see "*SFC's Enforcement 'Firsts' from 2009-2014*" on page 31), testing the boundaries of its powers, with mixed success. One notable innovation has been the transformative use of s.213 civil proceedings from a means of preventing dissipation of assets to a means of securing a return of assets to investors harmed by market misconduct. Another has been the targeting of offshore perpetrators of market misconduct, using s.213 civil proceedings to secure onshore assets on an interim basis and to obtain final restorative or compensatory relief, combined with Market Misconduct Tribunal (MMT) proceedings for a determination of wrongdoing and securing of market bans.

The SFC has also been at the forefront of introducing further reforms to protect investors. To name a few, these reforms include the introduction of a revised IPO sponsor regulatory regime and a new Corporate Regulation Team to more closely supervise the listing of companies in Hong Kong and their post-listing activities, as well as new electronic trading regulations to ensure fair and orderly trades and market integrity. These reforms provide the SFC with greater opportunities for surveillance and enforcement against market participants who fail to meet the standards required by law or regulation.

We expect the SFC will use these reforms, and further reforms to be introduced in the near future, to closely monitor market participants and hold them accountable for misconduct and regulatory failings. Market participants – including licensees and individuals in senior management roles – need to be especially vigilant.

[2] References herein to a section/sections (or s./ss.) are to a section/sections of the SFO, unless otherwise specified.

Overview of the SFC'S Activities 2009-2014

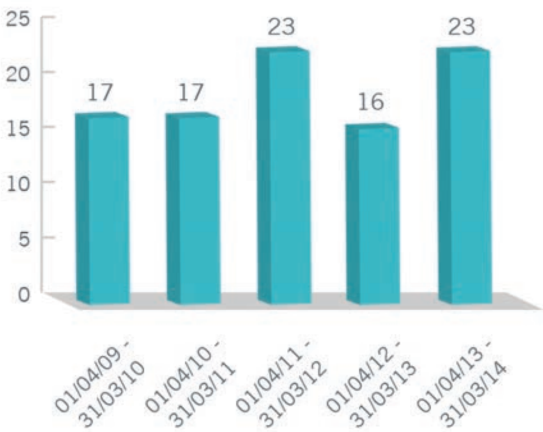
There has been an overall increase in the SFC's activities from 2009 to 2014 – in particular, in: enquiries made to listed companies under s.179; supervisory inspections under s.180; trading enquiries under s.181 for market surveillance and monitoring; investigations under s.182/183; the issuance of compliance advice letters alerting firms to compliance shortcomings; the use of search warrants; and the commencement of civil proceedings.

Fig. 1: Enforcement activities generally

Section 179 – Listed Company Enquiries

Section 179 enquiries increased by 35% over the review period. These are enquiries where the SFC has sought production of records and documents from listed companies, in cases of suspected fraud, defalcation, misfeasance, mismanagement and other misconduct associated with the listing or operations of the company, or where SFC members have not been given the information that they may reasonably expect.

Fig. 2: Enquiries issued under s.179 SFO

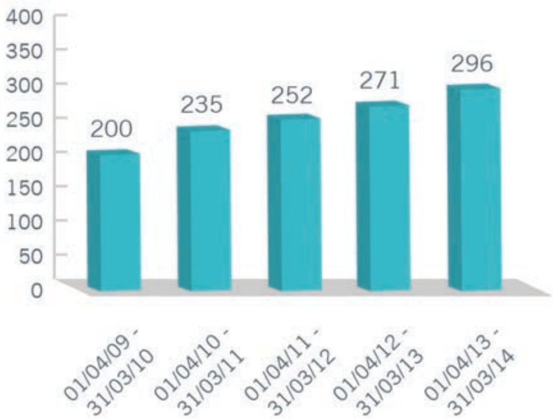


We expect the number of s.179 enquiries to increase, as this activity tracks the strong Hong Kong IPO market and the SFC's new Corporate Regulation Team established in 2014, increases its oversight of the listed sector, monitoring corporate information and disclosures to detect issues, and following up on them proactively. The SFC has held and will likely continue to hold senior management, and recently also "gatekeepers", accountable for the regulatory misdeeds of the companies they control and/or oversee.

Section 180 – Supervisory Inspections

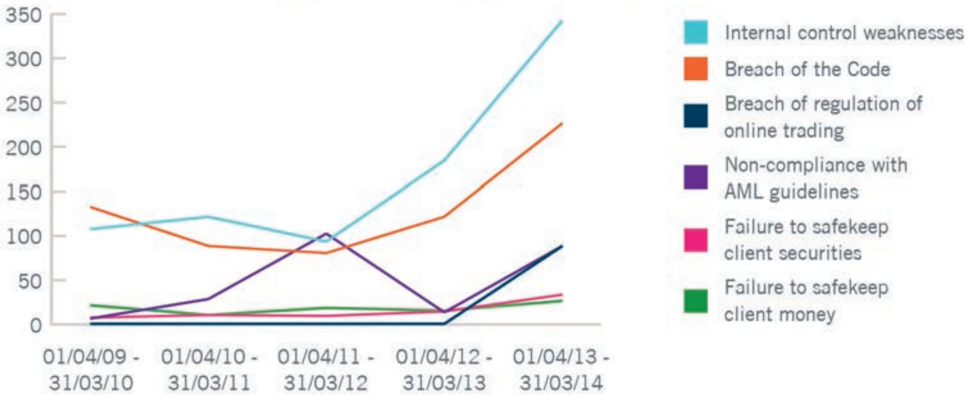
Over the review period, there has been a steady year-on-year increase in the number of s.180 supervisory inspections, with a 48% increase since 2009.

Fig. 3: Risk-based, on-site inspections conducted



The chart below sets out breaches noted by the SFC during on-site inspections.

Fig. 4: Breaches Noted by the SFC During On-site Inspections



The most common breaches noted were internal control weaknesses, followed by breaches of the Code of Conduct for Persons Licensed by or Registered with the SFC (Code). Non-compliance with anti-money laundering (AML) guidelines has come into prominence again since 2013/2014.

We expect to see an increase in the number and frequency of s.180 inspections, and a significant increase in the information requested during such inspections, continuing to focus on electronic trading controls, AML, and supervision and controls.

Section 181 – Trading Enquiries

There has been a steady increase in the number of s.181 trading enquiry letters sent over the review period, particularly during 2013/2014. These letters, which are issued for the SFC's market surveillance and monitoring functions, require production of certain trading information. They can be (but are not always) a prelude to a s.182 investigation.

Fig. 5: Trading enquiries issued under s.181 SFO (no. of letters sent)

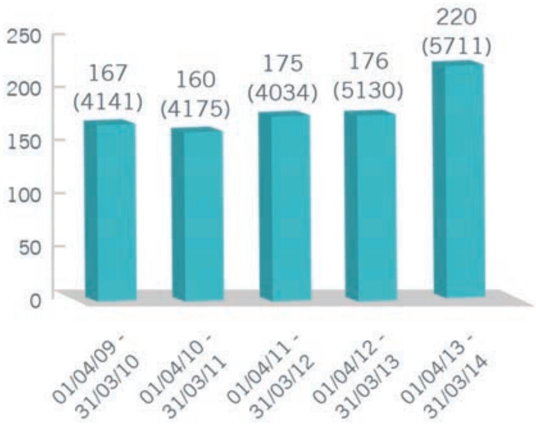
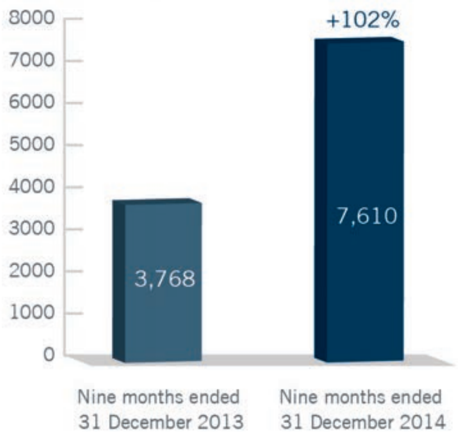


Fig. 6: Trading enquiry letters sent



We expect to see a very significant increase in s.181 enquiries issued – in particular, as the SFC continues its monitoring of electronic trading and the recently launched Shanghai-Hong Kong Stock Connect.

Section 182 – Enforcement Investigations

There has been a general increase in the number of s.182 investigations, with a sharp increase of 17% from 2013 to 2014. The trend is even more pronounced when one compares the most recently available data (Fig. 8): investigations increased by 70% over the prior period.

Fig. 7: Investigations started

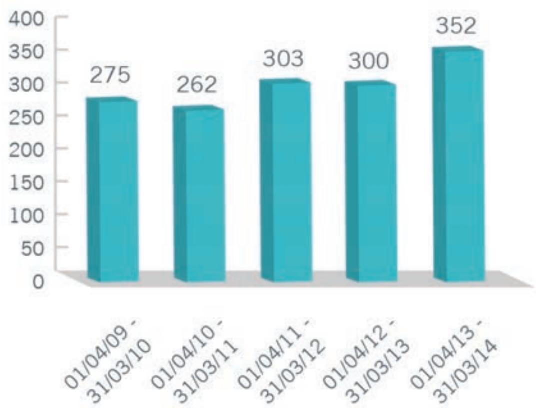
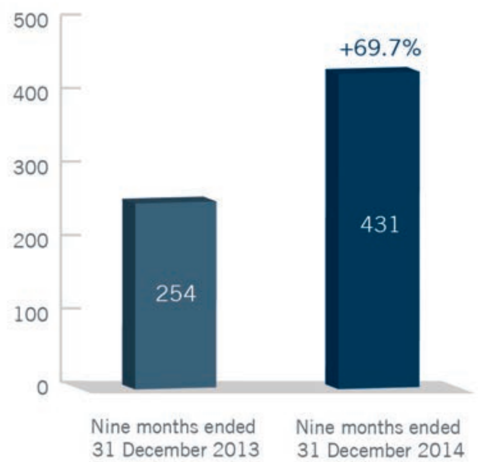


Fig. 8: Investigations started



We envisage the increase in s.182 investigations to continue as a result of recent regulatory reforms, including the new IPO sponsor regime, the recently launched Shanghai-Hong Kong Stock Connect, and the introduction of the new professional investor regime that will take effect on 25 March 2016.

Fig. 9: Investigations by nature

The chart above (Fig. 9) compares the different types of investigations. There has been an increase in the number of investigations across the SFC's five core programs, with the SFC's primary focus during this period being on intermediary misconduct. This is likely due to the vast range of regulatory breaches falling within this category, which our analysis shows is split largely across the four broad areas of account handling issues, internal control failings, order related issues, and sanctions against ROs. Crucially, both intermediaries and their senior management (including executive directors and ROs) have been investigated and subjected to disciplinary sanctions.

The next most frequent type of investigations during this period related to market manipulation and insider dealing which, together, encompass market misconduct issues under the SFO – issues that are more relevant to individuals than intermediaries. The frequency of such investigations corresponds to the SFC's increased emphasis on market surveillance and monitoring.

Investigations relating to corporate governance (including misgovernance and disclosure issues) had the highest increase across the core programs, with the increase in 2013-2014 likely caused by a jump in disclosure issues, coinciding with the Financial Services and Treasury Bureau's consultation on the proposed statutory regime for disclosure of price sensitive information (PSI) and the SFC's Consultation Paper on the Draft Guidelines on Disclosure of Inside Information that followed the entry into force of the new PSI disclosure regime.

Also of relevance to intermediaries are issues related to unlicensed activities, for which consistently the fewest number of investigations was commenced.

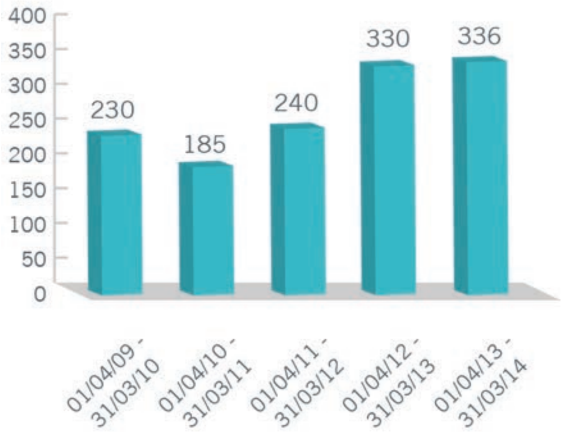
We expect the occurrence of such issues to increase substantially going forward given several recent SFC initiatives, including:

- *Its initiative to regulate companies' professionalism, conduct and culture.*
- *The SFC's monitoring of compliance with the new statutory obligation on listed companies to make "real time" disclosure of PSI under Part XIVA of the SFO, which took effect from January 2013.*
- *The creation of a new Corporate Regulation Team dedicated to reviewing company information and disclosures by listed companies to detect potential problems and pursue red flags.*

Compliance Advice Letters

The number of compliance advice letters issued by the SFC has increased notably (by 46%) over the review period, although the number has been relatively constant between 2013 and 2014. These letters identify areas that need to be addressed and/or standards of conduct and compliance that should be improved. Many compliance advice letters issued in the past year have related to senior management[3] and corporate responsibility failings, and to "new areas" including IT-related systems issues.[4] The SFC expects firms to take action to address concerns raised in compliance advice letters.

Fig. 10: Compliance advice letters issued

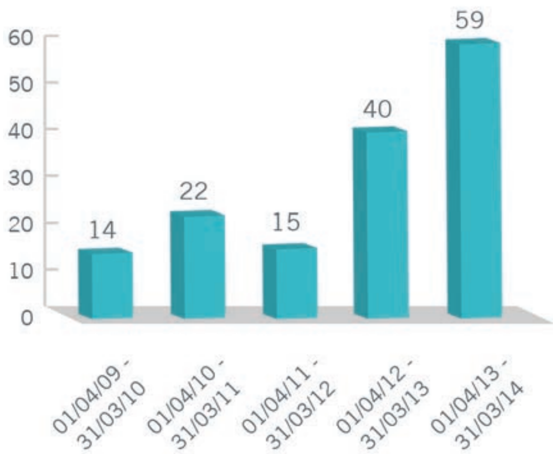


We expect the use of such letters to remain high with the increase in trading enquiries.

Section 191 – Search Warrants

The SFC's use of search warrants has increased markedly over the review period, particularly since 2012/2013. The SFC has extensive investigative powers under ss.179, 181 and 182 (among others), even without search warrants. The increased use of search warrants indicates that the SFC has had the need to secure information quickly. This

Fig. 11: Cases with search warrants executed



[3] "Management" includes the board of directors, managing director, chief executive officer, responsible offers, executive officers and other senior management personnel.

[4] Mark Steward, Executive Director of the SFC's Enforcement Division, Speech to the First SFC Supervisory Briefing for Market Intermediaries, 2 September 2014.

usually leads to an increase in costs to the subject of the search because of the need to conduct a thorough review of the seized materials to ensure that only relevant and non-legally privileged documents have been seized, and to challenge, where necessary, the seizure of such documents.

Going forward, we expect the SFC to continue to use search warrants to secure information at the start of investigations – in particular, in cases where it has discovered on-going or calculated wrongdoing or fraudulent conduct.

Market participants should ensure they have comprehensive "dawn raid" protocols, provide staff training on how to deal with a raid, and consider how best to set up their systems to prepare for this threat. For example, having privilege protocols would assist in protecting confidential legal advice from seizure and/or allow the market participants the opportunity to request the return of those documents from the SFC or apply to the courts if necessary.

Criminal Proceedings

The number of persons charged in criminal proceedings has stayed relatively constant between 2009 and 2014.

We expect the SFC's heightened market surveillance to increase the offences identified by the SFC, leading to an increase in the number of persons charged.

Sections 213-214 – Persons Subject to Ongoing Civil Proceedings

By contrast to the small increase in criminal proceedings, the number of civil proceedings in the same period increased by 102.9%. Of these, there has been a noticeable increase in proceedings against listed companies and/or their directors and officers under ss.212, 213 and 214, indicating that the SFC has been focussing on protection and restoration. Individuals have been held accountable, in line with the SFC's approach of holding management to account for misconduct by the companies they represent.

Some of the cases that have been before the courts have been ground breaking, testing the boundaries of the SFC's powers under the SFO. These include cases where the courts have supported the SFC's use of s.213 to freeze assets and obtain final restorative orders to recover and return assets to investors.

As the SFC sees itself acting as "a proxy for investors who are harmed by corporate misconduct",[5] and given the clarifications of the SFC's powers to use civil proceedings, we expect to see the number of persons subjected to civil proceedings continuing to rise.

[5] Ashley Alder, CEO of the SFC, Speech to the Hong Kong Institute of Chartered Secretaries' Corporate Governance Conference, 19 September 2014.

Section 212

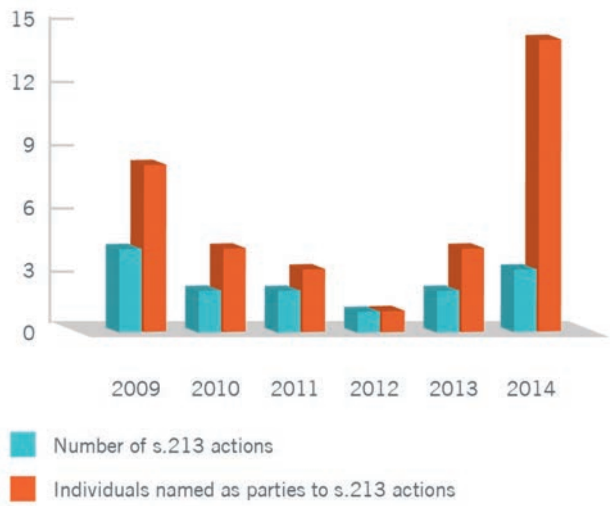
To date, the SFC has brought only two s.212 proceedings to wind up companies to protect the interests of the companies' shareholders and creditors, and/or the investing public.

We expect that the SFC will continue to use s.212 as and where necessary to safeguard investors' interests. However, such proceedings will continue to be used sparingly and only in extreme cases.

Section 213

A key development was the transformation of s.213 from a tool to secure assets through interim injunctions, to a method of securing a return of ill-gotten gains to investors (including against wrongdoers outside Hong Kong). Pursuant to s.213, the SFC may seek a range of orders from the courts (including freezing assets, restraining misconduct and providing restoration/compensation to victims of market misconduct) against companies and individuals (including senior management, directors and ROs).

Fig. 12: s.213 actions



From 2008 to 2010, many individuals were named as parties to applications under s.213, as the SFC sought and obtained several interim injunctions to freeze assets and safeguard investors' interests. As those proceedings worked their way through the courts, the number of s.213 proceedings issued decreased. However, the scope of the SFC's powers under s.213 was clarified in 2013, as the SFC obtained a number of important resolutions of previously issued s.213 proceedings (by consent and by order of the court). These included: Hontex International Holdings Limited (Hontex, the first final order for a share buy-back by a listed company); Tiger Asia Management LLC (Tiger Asia, confirming that s.213 is a free-standing remedy not requiring a prior determination of the criminal courts or MMT); Du Jun (the first restoration order for insider dealing); Tsoi Bun (restoration order for market manipulation in the futures market); and GOME Electrical Appliance Holdings Limited (GOME, agreement by the directors to compensate the company).

Following those successes, in 2013/2014 the SFC issued more s.213 proceedings, seeking both interim and final relief, against a greater number of individuals than in any previous year during the review period. In these new proceedings, the SFC named the relevant company, related companies and directors as parties.

We expect the number of s.213 proceedings to continue to rise as the SFC sees itself as the effective guardian of investors' interest (in the absence of a class action regime in Hong Kong) and increases both its international co-operation and pursuit of management. We expect a particular increase in the number of individuals named in those proceedings.

Section 214

Under s.214, the SFC may seek disqualification and/or compensation orders against directors of listed/formerly listed companies for conducting a company's affairs in a manner involving defalcation, fraud, misfeasance or other misconduct towards the company, or not giving members all the information they might reasonably expect.

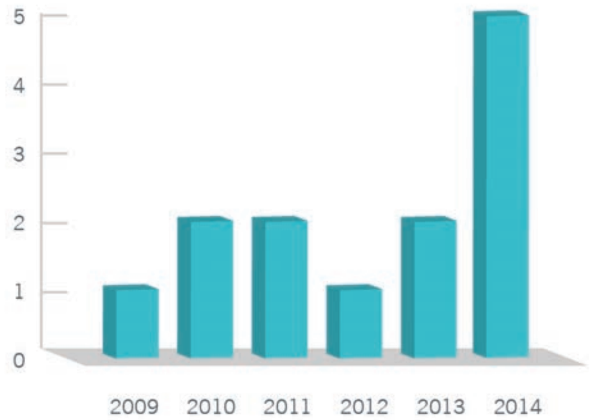
Fig. 13: s.214 actions

Given the focus of s.214 on the management of current or former listed companies, combined with the SFC's stated intention of holding management accountable, we expect that the number of s.214 proceedings will follow a similar track to s.213 proceedings, accompanied by a greater increase in the number of individuals subjected to those proceedings.

Market Misconduct Tribunal Proceedings

MMT proceedings had been stable until they sharply increased in 2013, when a number of MMT proceedings were brought after and/or together with s.213 proceedings, particularly in targeting offshore entities or individuals who had perpetrated market misconduct within the Hong Kong markets.

Fig. 14: MMT proceedings



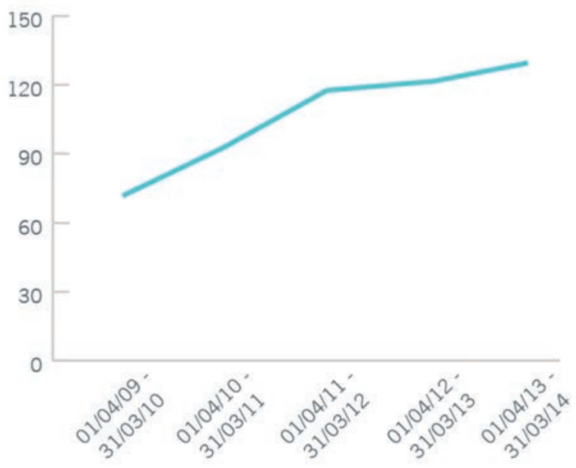
We expect the number of these proceedings to increase alongside the use of s.213 proceedings, particularly since the SFC was successful in defeating CITIC Limited's challenge to the simultaneous use of s.213 and MMT proceeding.[6] *We also expect the number of MMT proceedings to increase as the forum for determining issues in respect of the new regulatory regime for the disclosure of PSI.*

[6] *Chang Li Hsien Leslie v Securities and Futures Commission*, unreported, HCAL 164 of 2014, 18 February 2015, per Hon. Au J.

Intermediary Misconduct

From 2009 to 2014, intermediary misconduct consistently topped the SFC's enforcement activities, with the most investigations and enforcement actions.

Fig. 15: Intermediary misconduct-related investigations



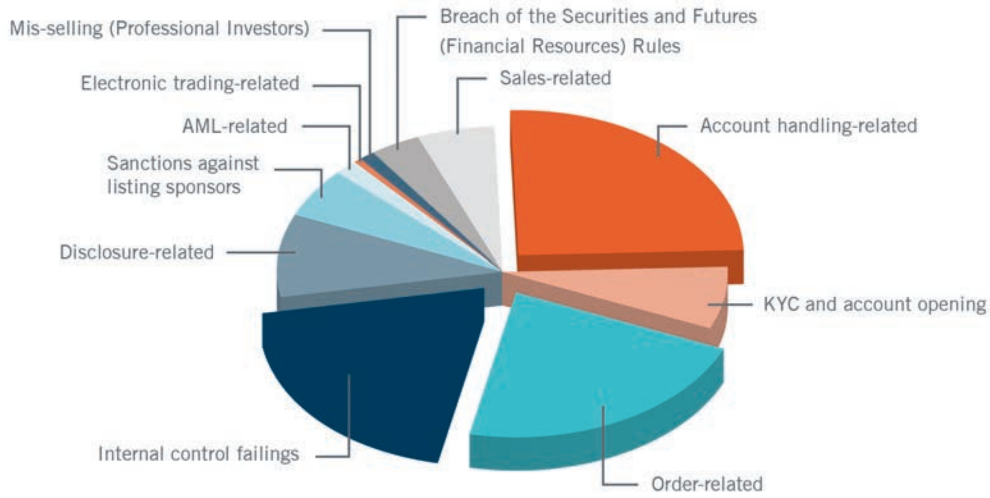
Scope

Intermediary misconduct covers a wide range of breaches and conduct, some of which will have been identified by the SFC whilst exercising its supervisory powers under s.180 during on-site inspections and/or through the use of s.181 trading enquiries, whilst others may have been picked up during general market surveillance.

To facilitate better understanding of the types of breaches and misconduct that fall within the SFC's broad categorisation of "intermediary misconduct" and the areas of risk to watch out for and remediate where necessary, we have analysed and set out (Fig. 16) a chart of the types and frequency of breaches sanctioned by the SFC during the review period.[7]

[7] There is often overlap in the type of misconduct sanctioned on any one occasion. We have categorised the SFC's sanctions as closely as possible to the type of misconduct. In some cases, the sanction has been counted twice because it clearly relates to two types of breaches. For example, where the SFC has sanctioned an intermediary for both internal control failings and AML breaches, we have categorised that in both categories.

Fig. 16: Disciplinary actions



The number of occurrences of each category of misconduct from 2009 to 2014, relative to the total number.

The three most prevalent breaches sanctioned as intermediary misconduct by the SFC are internal control failures, account handling breaches and order related breaches. The charts below (Fig. 17) show the types of misconduct that have been sanctioned under these three types of breach, which themselves are very broad.

Fig. 17: Sanctioned breaches

Issues related to internal control failures

- Breach of electronic trading regulations
- Weak data protection
- Inadequate record keeping
- Non-compliance with AML guidelines
- Lack of staff training
- Failure to ensure qualified staff
- Failure to disclose stock positions/position limit failures
- Failure to detect and prevent unauthorized/ improper conduct or trading
- Lack of product due diligence
- Inadequate procedures re KYC/account opening and handling/KYC/sales process
- Failure to keep client assets in safe custody
- Failure to ensure product suitability
- Management and supervision failures/ inadequacies

Account-handling-related issues

- Lack of authority for trades
- Complaint-handling failures
- Failing to reasonably safeguard client assets
- "Front running" client trades
- Providing false information to clients
- Failing to follow client intructions

Order-related issues

- Improper handling of error trades/"mis-marking" activities
- Negligence in handling client orders
- Failure to prevent clients from trading in an abusive manner
- Executing suspicious orders without determing genuine purpose
- Transaction settlement failings
- Failure to keep audit trail of orders

The sanctions imposed by the SFC for these and other intermediary misconduct have ranged from a public reprimand to revocation of licence and lifetime ban from re-entering the industry. The level of fines imposed has depended on the severity of the misconduct and whether investors have been affected, among other factors. Since 2011, the SFC has imposed more fines of at least HK$5 million, and in 2014 the SFC imposed almost as many fines of at least HK$5 million as during the previous three years combined, as the chart below (Fig. 18) demonstrates.

Fig. 18: Fines

Internal Control Failures

Most of the significant disciplinary sanctions from our review period related to internal control failures, in respect of issues such as:

- Providing inaccurate information to the SFC during a licence application process – reprimand and fine of HK$5 million against HSBC Securities Brokers (Asia) Limited in December 2013.
- Failing to prevent unauthorised trading activities by an employee – reprimand and fine of HK$6 million against The Royal Bank of Scotland PLC (RBS) in April 2014 (RBS' timely self-reporting was hailed by the SFC as a good example of accountability deserving of substantial credit and is the reason why the sanction was not heavier).
- Failing to conduct customer due diligence and perform ongoing scrutiny of accounts of certain subscribers for shares of Powerlong Real Estate Holdings Limited allotted through its listing – reprimand and fine of HK$12.5 million against each of ICBC International Capital Limited and ICBC International Securities Limited in May 2014.
- Failing to establish AML internal control procedures and to provide AML training to staff – reprimand and fine of HK$6 million against Ping An of China Securities Company Limited in July 2014. The SFC has since reminded market participants that money laundering risk assessment should be one of the major focus areas going forward.[8]

[8] Stephen Po, Senior Director of the SFC's Intermediaries Supervision Department, Speech to the first SFC supervisory briefing for market intermediaries, 2 September 2014.

Significant sanctions have also been imposed on IPO sponsors, such as: a fine of HK$42 million against Mega Capital (Asia) Company Limited (Mega Capital) and a revocation of its licence to advise on corporate finance in April 2012, for its role as sole sponsor for the listing of Hontex; and a reprimand and fine of HK$12 million against Sun Hung Kai International Limited (SHKI) and a one-year suspension of its licence to provide advisory service on corporate finance, for its role as sole sponsor for the listing of Sino-Life Group Limited (Sino-Life).

Account Handling-Related Breaches

Significant sanctions have been imposed for account handling-related breaches over the review period, although the fines have generally not been as high as those for internal control failures. The SFC has sanctioned licensed entities for account handling breaches – for instance, Merrill Lynch (Asia Pacific) Ltd was reprimanded and fined HK$3.5 million in August 2012 for failing to fully investigate the complaints of 11 clients who were subject to a fraud perpetrated by its former licensed representative. The SFC has also frequently sanctioned licensed individuals for such breaches, particularly where the actions have involved quasi-fraudulent conduct or the breach of duty owing to clients in handling accounts – for example: providing false information to clients to conceal trading losses (ban for life against Manesh Vijaykumar Samtani in April 2014); and "front-running" client's trading intentions for self-profit at the client's expense (revocation of licence and a fine of HK$930,000 against Chan Wang Fai in June 2009).

Order-Related Sanctions

Whilst there have been a large number of order-related breaches over the review period, the sanctions imposed have generally not been as significant relative to the other types of breaches noted above. Licensed entities have been sanctioned for failure to establish and/or maintain policies and procedures to ensure clear and comprehensive audit trails and the fair and equitable handling of client accounts (e.g., reprimand and fine of HK$800,000 against Chung Nam Securities Limited in August 2010). Licensed individuals have commonly been sanctioned for failing to make proper records of order instructions, or negligence in handling client's orders. Notably, both licensed entities and individuals (in some cases ROs) have been sanctioned for failing to prevent clients from placing suspicious orders or trading in an abusive manner, and not asking sufficient questions to determine the clients' genuine purpose of orders.

The SFC Holds ROs Accountable

Most of the SFC's sanctions in this core program, including for the top three types of breaches mentioned above, are against ROs. ROs have been held accountable for the broad range of failings of the intermediaries to which they are accredited. During each year of the review period, an average of seven to eight ROs were subject to disciplinary actions on the back of the failings of the relevant licensed complany. This is consistent with the views of the SFC's Intermediary Supervision and Enforcement departments that senior management is responsible for implementing proper controls, maintaining appropriate standards of conduct and adhering to proper procedures. The chart below (Fig. 19) sets outs the types of misconduct for which ROs have been sanctioned.

Fig. 19: Sanctioned breaches

Issues for which ROs have been sanctioned

- Weak data protection measures
- Insufficient management supervision over daily operations
- Order recording failures
- Failing to make adequate inquiries about suspicious activities
- Failure to prevent clients from trading in an abusive manner
- Failing to reasonably safeguard client securities/monies
- Allowing unauthorized persons to operate client account
- Internal control deficiencies
- Failure re role as IPO sponsor
- Employment of unlicensed staff
- Breach of the Securities and Futures (Financial Resources) Rules
- Lack of KYC due diligence/account opening procedures

Significant sanctions have been imposed on ROs for IPO sponsor failures – for instance: two ROs and sponsor principals for Mega Capital received, respectively, a licence revocation and a three-year ban; an RO and sponsor principal of SHKI received a three-year ban; and an RO of Core-Pacific Yamaichi Capital Limited (CPYC) was banned for six years in respect of CPYC's role as sponsor for the listing of Tungda Innovative Lighting Holdings Limited (Tungda).

Further, ROs have been sanctioned regularly alongside the licensed entities they represent, in internal control failings, order relating breaches and other actions. Notable examples include:

- China Everbright Securities – In April 2013, the SFC reprimanded China Everbright Securities (HK) Limited and fined it HK$1.2 million for failing to supervise its staff (operating in the office of its PRC affiliate) with respect to maintaining controls to ensure compliance by such staff with proper account opening and KYC procedures. The SFC also reprimanded an RO of China Everbright Securities and fined him HK$400,000, finding that such internal control failures were attributable to the RO's neglect in his capacity as a member of the senior management who oversaw daily business conduct.
- Sun On Tat – In September 2013, the SFC reprimanded Sun On Tat Securities Company Limited and fined it HK$1.6 million for various internal control failings related to (among other matters): allowing one client's securities to be used for settling transactions of another client; failure to promptly and properly deposit client securities in appropriate segregated accounts; and inadequate segregation of front office and back office duties. The SFC also reprimanded an RO of Sun On Tat who was responsible for overseeing its front and back office operations and its compliance function, and fined her HK$200,000 for managerial and supervisory failures.
- Salisbury Securities Limited – In October 2014, the SFC banned two ROs of Salisbury for life. One RO was found to have authorised the use of securities and monies belonging to other clients for the settlement of another client's instructions and for the discharge of Salisbury's operational expenses and personal expenses, as well as masterminding the window dressing activities of Salisbury's liquid capital. The other RO was found to have failed to keep himself informed of Salisbury's business and to participate at all in management. Salisbury was wound up by the Court pursuant to s.212 proceedings brought by the SFC.

Case Study on Cooperation with the SFC: The Value of Spontaneous and Prompt Reporting

The recent case of **Royal Bank of Scotland PLC** aptly demonstrates that spontaneous and prompt reporting of any material problem or improper conduct can amount to cooperation with the SFC justifying leniency, even where complying with an obligation to report regulatory breaches to the SFC immediately does not of itself do so.

In April 2014 the SFC reprimanded RBS and fined it HK$6 million for internal control failures in respect of "significant weaknesses in its procedures, management systems and internal controls".[9] The SFC found that RBS had failed to implement adequate systems and controls to detect and prevent unauthorised trading from May 2008 to October 2011, which a rogue trader in its Emerging Markets Rates business in Hong Kong (**Tsang**) exploited.

On Friday, 14 October 2011, RBS detected that Tsang had made significant losses through her bond trading, in a review of trading portfolios conducted internally.[10] Tsang's supervisor had two telephone conversations with her that same evening. The next afternoon, Saturday 15 October 2011, RBS self-reported to the SFC on an urgent basis, choosing not to wait until the next working day, Monday, 17 October 2011, to self-report. RBS also reported the incident to the HKMA and the police. At the time of its reports to the SFC, the HKMA and the police, RBS had not yet determined the full scale of the misconduct or its losses.

Despite the "extensiveness and prolonged nature"[11] of RBS' internal control failings and its obligation to report suspected breaches immediately, Mark Steward, Executive Director of the SFC's Enforcement Division, gave RBS "substantial credit" for acting quickly in notifying the SFC on a Saturday afternoon. In fact, he characterised RBS' actions as "quite unique", "the right thing without knowing what the costs might end up being" and "a success story for internal audit and for the right attitude and approach".[12] He also noted that, whilst the reduction of a public reprimand and a fine of HK$6 million – from a maximum penalty of a revocation or suspension of licence and a fine of HK$10 million – was "not quite a 'get out of jail free' card [RBS] may have wanted",[13] it showed the value of early and full co-operation with the SFC.

RBS' prompt reporting enabled the SFC immediately to ring fence the issue, and the police to prevent Tsang from leaving Hong Kong. On Monday, 17 October 2011, Tsang was arrested at the Hong Kong International Airport trying to fly to Toronto on a one-way ticket. She was subsequently convicted of fraud[14] and sentenced to four years and two months' imprisonment, reduced on appeal to three years and ten months.

Practical Take-Aways

- Licensed persons should closely monitor and promptly respond to internal control issues and report regulatory breaches.
- If a suspected breach is detected, move quickly to report to the SFC to contain the damage and obtain cooperation credit.

---

[9] SFC press release, 22 April 2014.

[10] Judgment of the Court of Appeal, 3 June 2014, CACC 349/2013, at para 14.

[11] Statement of Disciplinary Action, 22 April 2014, para 3.1.

[12] SFC press release, 22 April 2014.

[13] Mark Steward, Speech to the Asian Chief Audit Executives Leadership Forum 2014, 3 July 2014.

[14] Section16A Theft Ordinance (Cap. 210), bearing a maximum sentence of 14 years' imprisonment.

Regulatory Reform Broadening the Scope of Future Intermediary Misconduct

Over the review period, the SFC has introduced regulatory reform with a view to addressing and preventing some of the issues encountered in its supervision and enforcement activities. These regulatory developments, discussed below, give the SFC more tools to hold intermediaries accountable.

Revised IPO Sponsor Regime Requiring Frontloading of Sponsor Work

The SFC's revised regulatory regime for IPO sponsors sought to address the conduct of sponsors and to give them the mandate and responsibility for ensuring that proper due diligence is conducted for IPOs, to minimise the risk of a recurrence of cases such as Tungda, Hontex and SHKI.

The new regime,[15] which took effect from 1 October 2013, is preventative in nature, clarifies the obligations required of sponsors and requires due diligence to be completed at an earlier stage. It enables the SFC to scrutinise published application proof prospectuses, and to step in at an earlier pre-listing stage through enquiries and action for breaches of paragraph 17 of the Code. Importantly, it may help to prevent some listings that would otherwise proceed on the basis of misstated financials or poor due diligence.

We have so far not seen an increase in disciplinary actions against sponsors and their management or sanctions for breach of the revised sponsor regime, more than one year after its introduction. The SFC has, however, recently reiterated its call for sponsors to dig deeper into information and any red flags concerning listing applicants, and to take a more responsible, proactive and constructive role leading IPOs.[16] That, and the SFC's previous statements about sponsors' roles, accountability and responsibilities,[17] should be heeded by sponsors and their management.

A sponsor's ability to carry out deeper probes – to ensure true, accurate and complete disclosure to the public is made about a listing applicant – will be considered in determining whether the sponsor is fit and proper to be licensed. A sponsor's failure to perform its role and responsibilities under the new regime will no doubt result in sanctions.

---

[15] This regime includes a new paragraph 17 of the Code and amendments to the Corporate Finance Adviser Code of Conduct and the Additional Fit and Proper Guidelines, and changes to the Stock Exchange of Hong Kong (HKEx)'s Listing Rules and guidance letters to reflect sponsors' tasks under the new revised sponsor regime.

[16] Ashley Alder, *supra* note 5.

[17] For example, "sponsors have an important role to play in helping to protect the investing public" and "[s] ponsors and their senior staff will be held accountable for negligent, cavalier or dishonest conduct" (SFC press release dated 11 October 2011 relating to WAN Ten Lok and Sunny YAN Kwok Ting) and "[a sponsor's management is] ultimately responsible for the work carried out by the sponsor, and for the supervision of the sponsor work" and "such responsibilities cannot be delegated" (SFC Frequently Asked Questions on the sponsor regime, Q6).

The SFC confirmed on 22 August 2014[18] that it would not recommend statutory amendments to clarify sponsors' liability for false statements in a prospectus, because sponsors were already covered by the civil and criminal prospectus liability provisions of the Companies (Winding Up and Miscellaneous Provisions) Ordinance (CWUMPO). To date, we have not seen any civil court actions brought against sponsors under CWUMPO or the SFO.

We expect that investors may bring civil claims against sponsors under CWUMPO when the listed company and its management are insolvent or their assets are out of reach. Otherwise, investors may continue to rely on the SFC to issue s.213 proceedings against the listed company and its management to secure a return of funds to investors.

In very serious cases of deliberate or fraudulent prospectus misstatements, we expect the SFC will look to prosecute both the sponsors and management of the listed company (where they are located in Hong Kong), unless they can show that they reasonably believed the statement to be true. Sponsors that have not conducted adequate due diligence in line with their regulatory obligations may find it difficult to prove that their belief was reasonable.

Electronic and Algorithmic Trading

Another significant reform during the review period is the regulation of electronic trading – introduced to ensure that "almost instantaneous" automated electronic trading does not affect the integrity of the market and that direct market access and algorithmic trading are "conducted in a fair and orderly manner".[19] These new regulatory provisions[20] came into effect on 1 January 2014 and have already given rise to increased questions during s.180 supervision inspections and more s.181 trading enquiries and ss.182/183 investigations.

The amendments to the Code concerning electronic trading apply to any trading of securities and futures contracts listed or traded on an exchange, which is conducted electronically. The amendments contain general requirements for all electronic trading, as well as specific requirements for algorithmic trading, internet trading and direct market access. For further information regarding the key requirements, please refer to *A New Age of Electronic Trading Regulation in Asia?* in Dechert's *FS Quarterly Report* (December 2013).

Schedule 7 to the Code makes clear that at least one RO or executive officer must take responsibility for the management and supervision of the electronic trading system, and intermediaries must conduct "appropriate due diligence" on third-party providers of electronic trading systems.

[18] SFC, Supplemental Consultation Conclusions on the Regulation of IPO Sponsors – Prospectus Liability, 22 August 2014.

[19] SFC, Consultation paper on the regulation of electronic trading, 24 July 2012, para 2.

[20] The regulatory regime includes a new paragraph 18 of, and Schedule 7 to, the Code, as well as a new Part IV of the Fund Manager Code of Conduct.

The SFC has not issued any formal guidance on the new electronic trading rules or the requirement for "appropriate due diligence", but it has commented on the principles applicable to due diligence, including that an intermediary is expected to have a "sufficient level of technical expertise to explain and understand how the system operates … and to ensure that the system is fit for purpose, before adapting the system for use".[21]

To help intermediaries understand their due diligence requirements under the new electronic trading rules, industry groups have issued an Electronic Trading Information Template (ETIT), aimed at streamlining due diligence and establishing a common framework for information requests from electronic trading service providers.[22] It breaks down the new electronic trading provisions of the Code, summarises the requirements and provides illustrative questions to ask third-party providers. The SFC's head of Enforcement has cautiously welcomed the ETIT as "a sensible, mature and relevant starting point".[23]

The implementation of these new regulatory provisions has led to the SFC noting 88 breaches in this area in 2014. To date, there has only been one sanction related to electronic trading, which concerned conduct prior to the new regulatory regime taking effect.

Given the increased focus of s.180 surveillance, s181 trading enquiries and ss.182/183 investigations on electronic trading issues, we expect to see the first disciplinary sanction under these new provisions shortly, perhaps this year, with more to follow.

[21] Consultation conclusions on the regulation of electronic trading, SFC, 22 March 2013, para 112.

[22] Preface to Electronic Trading Information Template, AIMA, ASIFMA, Asia Trader Forum, FIX Trading Community and HKIFA, 7 October 2013.

[23] Mark Steward, Speech to 2nd Annual Compliance Summit Asia, *Beyond Compliance: Prudence and other Challenges*, 7 November 2013.

Case Study on Algorithmic Trading: Shedding Light on the Black Box

In May 2014, the SFC issued its first public sanction relating to algorithmic trading.[24] The SFC reprimanded Citigroup Global Markets Asia Limited for failing to ensure that orders placed through its algorithmic trading system "would not cause undue price impact to the market". While the trades took place between April 2009 and May 2010, the SFC noted that if the trades had occurred under the new electronic trading rules it would have imposed a "heavy fine".[25]

Since the introduction of the new electronic trading rules in 2014, the SFC has stepped up its regulatory oversight of algorithmic trading, including in order to illuminate the algorithmic trading market – two of its key concerns being market participants who perpetrate market misconduct anonymously shielded by such trading systems,[26] and intermediaries who facilitate such misconduct by design or by their lack of understanding or controls of the trading system.

SFC Maps the Algorithmic Trading Market

As part of this oversight, the SFC has issued enquiries and formal investigations relating to algorithmic trading. To facilitate the submission of the information sought, the SFC has made available templates on its website. These templates request the following information: name of the ultimate client; number of shares bought and sold; price; name of the person giving the order; name of the broker and responsible account executive; and whether the trade involved short selling. The information obtained through these enquiries and investigations will no doubt help the SFC to build a picture of the algorithmic trading market, shed some light on black box trading and address the issue of anonymity in practice.

Intermediaries to be Responsible for their Black Box, Whoever Created It

The SFC will also rely on the specific rules relating to algorithmic trading to hold intermediaries and their management accountable for any misconduct perpetrated through the use of the algorithmic trading system.

Under Section18 of, and Schedule 7 to, the Code, intermediaries are now required to:

- Establish policies to ensure the persons involved in the design, development and use of its algorithmic trading system are "suitably qualified". The SFC has not explained "suitably qualified", believing that the person that designs, develops and uses an algorithmic trading system is in the best position to determine who is suitably qualified.[27]
- Ensure their algorithmic trading systems and trading algorithms are "adequately tested to ensure they operate as designed", including testing the system at least annually.

---

[24] Section 18 of the Code defines algorithmic trading as "computer generated trading activities created by a predetermined set of rules aimed at delivering specific execution outcomes".

[25] *See* SFC press release, dated 14 May 2014.

[26] Mark Steward, Keynote address to the Fraud and Corruption Asia Pacific Summit, 20 June 2012.

[27] *See* footnote 15, *supra*, paragraph 85.

– Have controls to ensure the integrity of the algorithmic trading system and trading algorithms, and that they operate "in the interest of the integrity of the market".

Importantly, intermediaries, particularly their executive directors and ROs, are responsible for algorithmic trading systems developed in-house or by a third-party service provider. They must also ensure that persons approved to use their algorithmic trading system have a "good understanding" of the operation of the system and trading algorithms and related compliance and regulatory issues, and are timely informed of any changes to the design and development of the system and trading algorithms.

SFC Looking for its First Algorithmic Sanction Under the New Regulations

We expect the SFC to continue issuing enquiries and investigations into algorithmic trading. Whilst it is likely that the SFC may issue Compliance Advice Letters for algorithmic trading failings, particularly with the increase in their use over the last five years, we expect the SFC will take disciplinary action for serious failings. As such, we anticipate the market will not have to wait long to see the SFC's first algorithmic trading sanction under the new regulations, and will then learn the level of "heavy fines" that will be imposed on intermediaries and their executive officers and/or ROs for breaching the new rules.

Given the regulatory requirements to ensure the adequacy of third-party systems and training of third-party users and practical difficulties with complying with those requirements, the early sanctions under the new regime may involve an algorithmic trading system that has been created by one party and supplied for another party's use.

Practical Take-Aways

– All market participants that provide or use algorithmic trading systems should consider whether they fall within the scope of the new regulations. Where market participants do fall within the scope of the new regulations, they should be well versed, and comply, with their responsibilities under the regulations.

– Executive directors and ROs should be particularly vigilant, given the SFC's focus on holding executives and management accountable.

– Licensed persons using a third-party algorithmic trading system should take particular care in conducting due diligence on their providers.

– Licensed providers of algorithmic trading systems should ensure their clients are sufficiently trained in their systems.

A New Dawn for Contractual Mis-selling Actions?

An area of intermediary misconduct that has not featured much in the enforcement statistics is mis-selling – despite the financial crisis and the more than 15,000 mis-selling complaints (including those relating to the Lehman Brothers mini-bonds) that the HKMA referred to the SFC by the end of 2008.[28] This is because the SFC leveraged its Damocles' sword of sanctions for the totality of the conduct involved – including a potential fine of up to three times the profit gained/loss avoided from the entire conduct – and brokered settlements under s.201 with distributors of mini-bonds and other Lehman Brothers structured products, adopting a "top-down" approach to complaints, focussing on the totality of the conduct, the policies and procedures in place and seeking redress for consumers as a whole.

By the end of 2009, the SFC had completed its investigations into the sale of Lehman Brothers mini-bonds, widely sold to retail customers by 19 distributors, reaching repurchase agreements with all 19 distributors and imposing reprimands for internal control failings in two cases. The SFC reached four further repurchase settlements relating to the sale of other Lehman Brothers structured products in March, May and July 2011 and July 2013, with no sanctions imposed in three cases and a reprimand in the last case.

These settlements represented a novel way of settling mass complaints by retail customers in a jurisdiction that does not have a class action framework. They helped reduce the sanctions imposed but did not avoid a sanction in every case. In August 2012, a licensed entity was reprimanded and fined HK$4 million for mis-selling non-SFC authorised funds, despite agreeing to a repurchase offer, although its licence was not suspended. In contrast, in May 2011, a licensed entity that did not agree to a repurchase offer was reprimanded, fined HK$3 million and prohibited for two years from dealing in over-the-counter and non-exchange traded structured notes.

SFC Enhances Selling Regime and Seeks Contractual Obligations to Comply with the Code

Based on the lessons learnt, in June 2011, amendments to the Code came into effect relating to obligations to ascertain clients' knowledge of derivatives and the knowledge of professional investors (PIs) as to the products being sold. These amendments did not require any amendment to client agreements and, in a series of judgments starting in 2012 concerning alleged mis-selling during the global financial crisis,[29] the courts refused to award damages claimed by PIs based on the contractual terms. In doing so, the courts

[28] Mark Steward, Keynote address to the 4th Annual Wealth Management Conference, 23 October 2008.

[29] These judgments include *Kwok Wai Hing Selina v HSBC Private Bank (Suisse) SA* [2012] HKEC 903 (CFI, 21 June 2012); *DBS Bank (Hong Kong) Ltd v San-Hot HK Industrial Co Ltd and Anor* [2013] HKEC 352 (CFI, 12 March 2013); *Shum Kin Yee v DBS Bank Hong Kong Ltd* [2013] HKEC 1194 (CFI, 31 July 2013); *Great City Enterprises Ltd v UBS AG* [2013] HKEC 18998 (CFI, 29 November 2013); and *Ko Wang Ming v Hong Kong Forex Investment Ltd* [2013] HKEC 2053 (CFI, 27 December 2013).

have relied on contractual provisions establishing a specific relationship between the parties and avoiding liability for any advice given by the seller of the investment products, and have held that the obligations of licensed persons under the Code should not be implied into contracts, especially where they contradict the express contractual terms. In a number of these cases, the courts have also found that the PI was an unreliable witness, highlighting the importance of giving considered, honest and believable evidence.

Following the first of these cases, in May 2013, the SFC issued a consultation on proposed amendments to the PI regime and client agreements.[30] The regulatory amendments set out in the consultation conclusions[31] will require, with effect from 25 March 2016, intermediaries to treat individual PIs in the same way as retail investors (save for certain administrative requirements), and to conduct a principles-based assessment to determine how to treat corporate PIs. The SFC has issued a further consultation on a mandatory clause for all client agreements, contractually incorporating a regulatory requirement to ensure the suitability of product recommendations and solicitations. In respect of objections that prescribed contractual terms are contrary to freedom of contract, the SFC indicated that "[f]reedom of contract simply does not apply in this regulated environment".[32] The SFC will also introduce a new obligation in the Code (to take effect on a date to be specified following the further consultation) to prohibit client agreement terms that are inconsistent with intermediaries' obligations under the Code.

These further regulatory amendments, which require the incorporation of regulatory obligations into client agreements, should lead to greater success for investors before the courts and provide further incentive for licensed corporations to ensure that their staff is complying with their regulatory obligations in the selling process.

Outlook for Intermediary Misconduct

The increase in the number of disciplinary actions related to intermediary misconduct shows no signs of slowing down in 2015 and beyond.

We expect the SFC will continue to rely on the broad categories of internal control failures and breaches of the Code in sanctioning intermediaries. We also expect AML-related breaches to be the subject of future sanctions.

Several areas of regulatory reform over the review period – including the revised sponsor regime that will lead to earlier surveillance of IPO sponsors, the new electronic trading regulations, and the extension of trades handled by intermediaries following the launch of Shanghai-Hong Kong Stock Connect – will provide the SFC with further opportunity to hold intermediaries, and/or their management and ROs, accountable for regulatory misconduct and should result in a rise in the number of investigations of intermediary misconduct.

[30] Consultation Paper on the Proposed Amendments to the Professional Investor Regime and the Client Agreement Requirements.

[31] Consultation Conclusions on the Proposed Amendments to the Professional Investor Regime and Further Consultation on the Client Agreement Requirements, 25 September 2014.

[32] *Ibid.*, para 50(a).

The SFC's revisions to the Code relating to the suitability requirement, and a possible Shenzhen-Hong Kong Stock Connect scheme, will likely broaden the scope of misconduct for which the SFC will be able to sanction intermediaries. Additionally, the SFC's proposed new client agreement requirements, should they take effect, may open the door for investors to seek redress for mis-selling directly from intermediaries through court actions. This would, in practice, supersede the previous court judgments on mis-selling and be most beneficial to PIs, who have substantial claims but have failed to overcome their contractual agreements in the courts. This may also lead to an increase in more efficient "follow-on" disciplinary actions whereby the SFC imposes sanctions following court rulings.

Intermediary misconduct should therefore remain the core focus of enforcement investigations, although corporate misgovernance may catch up over time.

Unlicensed Activities

Scope

Over the last five years, the SFC has continued its market surveillance of unlicensed activities – investigating and taking enforcement action against entities and individuals who engaged in unlicensed activities, as well as those facilitating such activities. As with its other core programmes, the SFC has pursued criminal, civil and disciplinary proceedings, and targeted activities both inside and outside Hong Kong.

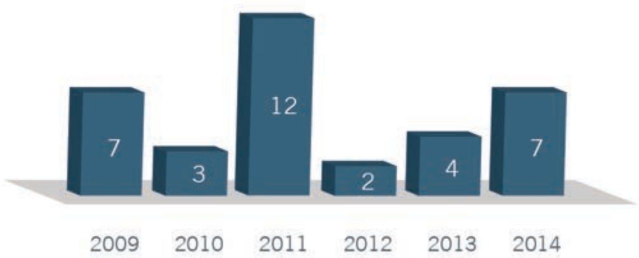
With its views that unlicensed activities undertaken, or assisted, by employees of a licensed corporation indicate a lack of internal controls, and that "[c]ompliance belongs not only at the heart of business but also at the top of senior management's responsibilities",[33] the SFC has successfully targeted licensed corporations and their management who aid and abet unlicensed activities, and has subjected them to heavy disciplinary sanctions.

The SFC's Toolkit for Addressing Unlicensed Activities

Criminal Prosecutions

The SFC, working with the Department of Justice (DoJ), has pursued and secured criminal convictions under s.109 (issuing an advertisement relating to carrying on regulated activities without a licence), s.114 (carrying on business in regulated activities without a licence) and s.390 (liability of officers of corporations for offences by corporations), as well as for aiding and abetting such offences. These included four convictions in 2009 for unlicensed dealing on accounts held by one Macanese entity.[34]

Fig. 20: Convictions for Unlicensed Dealing and Advertising (2009-2014)



Most of the prosecutions for unlicensed dealing have been on a summary basis, where the magistrates' courts have power on conviction to impose a fine of up to HK$500,000 and up to two years' imprisonment. The criminal sanctions imposed so far have ranged from fines, to community service orders and imprisonment. Of note:

- Over the review period, the fines have increased.
- In December 2011, the SFC secured a community service order of 80 hours.[35]
- Since 2013, custodial sentences have been imposed (although these were suspended). The sanctions ranged from four weeks to six months.

33 *See* SFC press release, 24 March 2009.

34 *See* SFC press releases dated 6 April 2009, 7 September 2009 and 8 December 2009.

35 *See* SFC press releases, 15 December 2011 and 14 May 2012.

- In April 2014, the sole shareholder-director of a company was convicted under s.390 – a provision that holds officers liable for the offences of their companies – when her company held itself out as providing corporate finance advisory services, although it did not have a licence to do so. Following a not guilty plea, the shareholder-director was convicted and sentenced to six months' imprisonment, suspended for 18 months,[36] and fined HK$600,000. This conviction has been appealed.
- In May 2014, the SFC commenced the first prosecution of a case for unlicensed dealings involving a collective investment scheme. The case was transferred to the District Court for prosecution on indictment on 13 January 2015, with the trial date fixed for November 2015. On conviction on indictment, the court can impose a fine of up to HK$5 million and seven years' imprisonment.

Civil Proceedings

The SFC also initiated civil proceedings, seeking and obtaining, among other remedies:

- A court declaration that dealing without a licence in securities in a grey market (prior to listing) constitutes unlicensed dealing under the SFO.[37]
- Orders for the winding-up and appointment of liquidators over insolvent companies that had engaged in unlicensed dealing.[38]

In December 2014, the SFC issued its first s.213 proceedings in relation to unlicensed activities – freezing the bank accounts of three companies and securing HK$4.3 million (the proceeds of unlicensed or boiler room activities carried out using the companies' respective websites); in January 2015, the SFC obtained orders restraining these companies from carrying on unlicensed activities and suspending their websites.[39]

Disciplinary Actions

The SFC has pursued disciplinary proceedings against licensed corporations and their management who assisted or failed to prevent unlicensed activities, imposing various sanctions such as:

- Revocation of an entity's licence (including the first such revocation, imposed in March 2009 after nine of the licensed entity's staff, including staff from a related company, were convicted of unlicensed activities).
- Reprimands and fines imposed on licensed entities.
- Suspension of the licences of persons who facilitated unlicensed activities.
- Suspensions, fines and reprimands imposed against ROs who encouraged or failed to prevent unlicensed activities.

---

[36] *See* SFC press release, 19 May 2014.

[37] *See* SFC press release, 26 May 2009.

[38] *See* SFC press releases, 12 September 2008, 19 September 2008, 26 March 2009 and 21 July 2009.

[39] *See* SFC press releases, 19 December 2014 and 7 January 2015.

No Safe Harbour Outside Hong Kong

The SFC recently also demonstrated it will take action against unlicensed activities conducted extra-territorially.

On 28 January 2014, the SFC issued a circular on Regulatory Compliance regarding Cross-border Business Activities, reminding licensed corporations of their obligations (under paragraph 12.1 of the Code of Conduct) to comply with the law and relevant regulatory requirements. The SFC noted that this included compliance with all legal and regulatory requirements in respect of their activities "whether in or outside Hong Kong".[40]

Reinforcing this message, on 7 May 2014, the SFC reprimanded Kaiser Securities Limited and Kaiser Futures Limited (together, Kaiser), two licensed corporations, and fined them HK$1 million and HK$700,000, respectively, for breaching Macanese law by conducting financial activities between 2004 and 2011 without authorisation in Macau. The SFC sanctioned Kaiser for a failure of its obligation to be fit and proper.

Unlicensed Activities and Related Enforcement Actions are on the Rise Again

Following a lull of two years, there was a resurgence of unlicensed activities in 2014 – and, along with such activities, investigations and enforcement actions by the SFC.

We expect the SFC to: take further action against unlicensed activities, particularly targeting management; pursue unlicensed activities outside Hong Kong wherever it has the power to do so; and use s.213 proceedings to suspend such activities and freeze related proceeds pending the resolution of the enforcement actions. Given the increase in the severity of criminal sanctions,[41] we also expect to see further prison terms imposed for unlicensed dealing, including unsuspended sentences.

Licensed corporations and ROs will continue to be held to account if they facilitate or fail to detect and prevent such activities, particularly within their organisations. They should take action to monitor for and prevent unlicensed activities within, or assisted by those within, their organisations.

[40] SFC Circular, "Regulatory Compliance regarding Cross-border Business Activities", 28 January 2014.

[41] On 13 January 2015, magistrates transferred to the District Court the first prosecution of a case for unlicensed dealings involving collective investment schemes. *See* SFC press release dated 13 January 2015.

Breakdown of the More Prevalent Sanctioned Breaches

Issues for which ROs have been sanctioned

- Weak data protection measures
- Insufficient management supervision over daily operations
- Order recording failures
- Failing to make adequate inquiries about suspicious activities
- Failure to prevent clients from trading in an abusive manner
- Failing to reasonably safeguard client securities/monies
- Allowing unauthorized persons to operate client account
- Internal control deficiencies
- Failure re role as IPO sponsor
- Employment of unlicensed staff
- Breach of the Securities and Futures (Financial Resources) Rules
- Lack of KYC due diligence/account opening procedures

Issues related to internal control failures

- Breach of electronic trading regulations
- Weak data protection
- Inadequate record keeping
- Non-compliance with AML guidelines
- Lack of staff training
- Failure to ensure qualified staff
- Failure to disclose stock positions/ position limit failures
- Failure to detect and prevent unauthorized/improper conduct or trading
- Lack of product due diligence
- Inadequate procedures re KYC/account opening and handling/KYC/sales process
- Failure to keep client assets in safe custody
- Failure to ensure product suitability
- Management and supervision failures/ inadequacies

Order-related issues

- Improper handling of error trades/“mis-marking” activities
- Negligence in handling client orders
- Failure to prevent clients from trading in an abusive manner
- Executing suspicious orders without determing genuine purpose
- Transaction settlement failings
- Failure to keep audit trail of orders

Account-handling-related issues

- Lack of authority for trades
- Complaint-handling failures
- Failing to reasonably safeguard client assets
- “Front running” client trades
- Providing false information to clients
- Failing to follow client intructions

SFC Enforcement "Firsts" from 2009-2014

24 March 2009 – First revocation of a corporation's licence (for a complete failure of compliance systems and controls within the corporation, particularly in relation to unlicensed activities and cold calling).

11 March and 1 April 2009 – First convictions and jail sentences for insider dealing in Hong Kong, ordered in the first criminal (and indictable) prosecution for insider dealing.

23 April 2009 – First criminal prosecution for disclosing false or misleading information inducing transactions under s.298 (brought on indictment for omission of allegedly material facts). The defendant was acquitted on 15 March 2012 due to, among other reasons, insufficient evidence that he was involved in the announcement.

13 and 26 November 2009 – First convictions and jail sentences for market manipulation in Hong Kong, ordered in the first criminal prosecution, and first indictable trial, for market manipulation.

9 February 2010 – First s.184(d) convictions on indictment for failure to answer questions in an s.183 interview.

18 March 2010 – First s.214 order 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).

1 March 2011 – First s.214 disqualification order against an alternate non-executive director of a listed company for failing to timely disclose material information to the market.

30 January 2012 – First conviction for market manipulation in the Hong Kong futures markets (on five counts, following acquittal in February 2010 and retrial ordered by the Court of First Instance in June 2011). This was followed in January 2014 by an s.213 restoration order to pay approximately 500 counterparties a total of HK$13.7 million for 49 similar contraventions.

7 March 2012 – First s.214 compensation order requiring former directors to pay compensation to the company.

20 June 2012 – First s.213 final order requiring a company to make a repurchase offer to investors.

22 and 31 October 2012 – First conviction and jail sentence of a director of a listed company for market manipulation (price rigging).

11 July 2013 – First MMT notice issued by the SFC directly.

29 July 2013 – First petition to wind up a listed company under s.212.

12 December 2013 – First s.213 restoration order for insider dealing.

31 May 2014 – First prosecution for unlicensed dealing in a collective investment scheme.

23 June 2014 – First simultaneous filing of s.213 and MMT proceedings.

22 December 2014 – First MMT proceedings against a short seller for misconduct in research publications.

Contributors

Kareena Teh
Partner, Litigation and contentious regulatory
Hong Kong
+852 3518 4717
kareena.teh@dechert.com

Howard Chan
Associate, Litigation and contentious regulatory
Hong Kong
+852 3518 4731
howard.chan@dechert.com

Additional Key Contacts

Angelyn Lim
Partner, Investment funds and non-contentious regulatory
Hong Kong
+852 3518 4718
angelyn.lim@dechert.com

Karl Paulson Egbert
Partner (Consultant in Hong Kong), Investment funds and non-contentious regulatory
Admitted in New York and the District of Columbia
+852 3518 4738
karl.egbert@dechert.com

Dean Collins
Partner, Investment funds
Singapore
+65 6808 6348
dean.collins@dechert.com

A global specialist law firm focused on sectors with the greatest complexities and highest regulatory demands, Dechert delivers practical commercial insight and judgment to our clients' most important matters. Nothing stands in the way of giving clients the best of the firm's entrepreneurial energy and seamless collaboration in a way that is distinctively Dechert.

Our Asia regulatory lawyers have extensive experience acting for financial services clients and are qualified to practice in several jurisdictions. With our deep legal expertise and understanding of our clients' businesses, we deliver practical guidance in disputes and investigations and bold advocacy at trial, in arbitration and before regulators. We regularly advise and represent clients in cross-border litigation and international arbitration, internal regulatory compliance investigations and external investigations by financial regulators and the police, providing specific compliance and contractual advice as needed.

Dechert LLP