26 Feb FA Panel Meeting follow up questions

In relation to Hon Emily Lau's concern about the manpower resources allocated for the investigation of Lehman related complaints, the SFC was requested to provide information on the number of cases awaiting investigation and the number of existing and/or new SFC staff deployed to investigate these complaints.

Reply

- The investigation into the Lehman incident has been one of the SFC's highest priorities since September of last year and considerable resources have been devoted to this task.

- The SFC adopts a top-down investigation examining whether the sale of these products was the result of any systemic weakness or failure of management controls. Our objective is to deal efficiently and effectively with the many complaints that have been lodged with ourselves and the Hong Kong Monetary Authority.

- In January 2009, we were pleased to announce the conclusion of our first investigation into the sale of Minibonds. This has resulted in an agreement with a brokerage to fully compensate eligible investors with their purchase cost.

- The SFC measures the number of investigations completed within 7 months targeting a completion rate of 80%. Using this measure, our completion rate at December 2006 was 36%. We have made deliberate and conscious steps to improve our methodology and to demonstrate that we are capable of world class efficiency. As at December 2008, our completion rate has improved to 85% of all cases.

- We publish these figures in our Enforcement Reporter on a regular basis (See Enforcement Report January 2009).

- This target does not mean we believe every investigation can be completed within 7 months or less. We know from experience that many investigations can take longer than 7 months for good reasons.

- Our aim is to conduct investigations thoroughly and fairly whilst also as efficiently and expediently as possible.

- Our completion rate of 85% in 7 months is comparable to relevant benchmarks:

  - the UK FSA discloses that the average length of an investigation is 10.6 months (see Enforcement Annual Performance Account 2007-2008).

  - the SEC measures the time it takes from the start of an investigation to the time a case goes to court targetting 60% of cases. It exceeds this target by 2% (see SEC Annual Report 2008).

- the ASIC Annual Report 2007-2008 discloses that ASIC targets 50% of investigations to be concluded within 6 months meeting that target in 36% of cases, also disclosing that 33% of investigations are concluded after 12 months.

- We know of no other enforcement agency in Hong Kong publishing the time it takes to complete investigations.

- In terms of resources allocation, the SFC has no investigations waiting in a queue at the moment. Every case is resourced, planned, managed and measured at this point of time. However, in view of the large volume of work arising from the new challenges thrown up by the financial tsunami, it is possible that we may need to provide additional manpower resources in the course of the next financial year.

SFC 證監會

ENFORCEMENT REPORTER

ISSUE NO. 61
January 2009

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

What have we been doing?

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

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

From 2 October to 31 December 2008, we sent 86 compliance advice letters when we became aware of conduct that presented unnecessary risks or which might lead to crime or market misconduct.

During the same period, we completed 57 enforcement cases (including the issue of six disciplinary notices of decision), and commenced 11 criminal proceedings.

A busy time in courts and tribunals

Several trials and hearings arising from the Securities and Futures Commission's (SFC) enforcement work have been scheduled for the coming weeks. These cases deal with important issues, including insider dealing, market manipulation, false trading and corporate governance.

- An insider dealing trial regarding dealing in the shares of Chi Cheung Investment Co, Ltd is scheduled to commence in the Eastern Magistracy on 3 February 2009.
- The Insider Dealing Tribunal has been scheduled to hear a case concerning Founder Holdings Ltd from 13 January 2009 until 13 February 2009.
- The Market Misconduct Tribunal will hear a case concerning allegations of false trading, price rigging and/or stock market manipulation in the shares of QPL International Holdings Ltd from 9 to 18 February 2009.
- A director disqualification hearing will be held in the High Court in respect of Chow Chun Kwong on 30 January 2009.

Highlights

- From 2 October to 31 December 2008, the Securities and Futures Commission completed 86 enforcement cases (including the issue of six disciplinary notices of decision), and commenced 11 criminal proceedings.
- A disqualification order was obtained from the High Court against a former director of a delisted company. This was the second time that the SFC had obtained a disqualification order.
- A bank was reprimanded for failing to treat clients fairly.
- A foreign securities house was reprimanded for failing to address potential conflicts of interest.
- The Securities and Futures Appeals Tribunal backed the SFC's decisions to penalise negligent behaviour and failure to observe due diligence.

SFC investigations: challenges and improvements

The commencement of these cases and recent publicity about investigations arising from the market turmoil has triggered renewed attention in the SFC's enforcement work . It seems that many people are interested in what is involved in a typical SFC investigation and that there are common misconceptions as to what is involved. We would like to clarify the following:

- An investigation does not mean that someone has done anything wrong; it simply signifies grounds or reasons to suspect something may have gone wrong. Investigations can end without any further action being taken.
- The function of an investigator is to find out the real facts and to do so patiently on the basis of cogent and reliable evidence. The investigator must pursue all relevant lines of inquiry and not just those that favour one side or one perspective.
- The investigator needs to deal with a large number of people and organisations when collecting evidence and quite often some people are not cooperative or are unable to assist as soon as the investigator might like. An investigation will often involve many thousands of documents, which need to be carefully sifted and analysed before interviews with witnesses can be completed. All sorts of issues outside the control of the SFC can influence the time it takes to complete an investigation.

For example, one investigation requires the SFC to interview over 50 different witnesses, many of whom do not live or work in Hong Kong. Scheduling interviews in different countries with such a large number of people is a complex, time-consuming exercise.

In the Enforcement Reporter (Issue No. 57, January 2008) we announced that we aimed to complete most of our investigations within seven months. When we first measured our performance in December 2006, we found that we were completing 36% of our investigations within seven months. By December 2007, the figure had improved to 71%. Taking into account all investigations handled during 2008, we have completed 85% of our investigations within that self-imposed timeframe.

Since the beginning of 2008, the number of investigations we are handling has increased by nearly 39%. More significantly, the number of investigations classified as complex, which require significant resources, has more than doubled (from 20% of all cases at the start of last year to over 40% by end-December). This means more investigations than before involve large or substantial transactions and events, multiple resources and complex legal and factual issues.

We expect these trends to continue and we will continue our efforts to improve our overall efficiency.

Listed company director disqualification: protection of the public and general deterrence

In the last issue of the Enforcement Reporter (Issue No. 60, October 2008), we announced the start of three separate proceedings in the High Court seeking orders (including disqualification orders) against nine company directors under section 214 of the Securities and Futures Ordinance.

Recently, the SFC obtained an order in the High Court against Mr Ong Hong Hoon (Ong), a former director of GP NanoTechnology Group Ltd (GP Nano), disqualifying him from being a company director or being involved in the management of any company (without court approval) for a period of five years.

The SFC alleged that Ong had acted with gross incompetence by:

- providing misleading information to the market in two announcements;
- abdicating responsibility as director of a listed company;
- failing to exercise reasonable skill, care and diligence and/or to act in the best interests of the company;
- misrepresenting or misstating his own duties as executive director in the company's prospectus and annual reports; and

- failing to ensure the company complied with the Rules Governing the Listing of Securities on the Growth Enterprise Market (GEM) of The Stock Exchange of Hong Kong Ltd (SEHK) and the Code on Takeovers and Mergers.

The Honourable Madam Justice Kwan stated that when exercising the jurisdiction to make disqualification orders, the court would consider two important objectives:

- protection of the public against the future conduct of persons whose past records as directors of listed companies have shown them to be a danger to those who have dealt with the companies, including creditors, shareholders, investors and consumers; and
- general deterrence in that the sentence must reflect the gravity of the conduct complained of so that members of the business community are given a clear message that if they break the trust reposed in them they will receive proper punishment.

In this case, the Carecraft procedure was adopted. This procedure, which involves the parties presenting agreed facts to the Court with a view to reaching a compromise, is an efficient means of disposing of disqualification proceedings as it avoids lengthy hearings and minimises the legal costs for all parties concerned. In addition, in Ong's case, the disqualification period ordered reflected his cooperation with the SFC and the admission of the complaints against him in the form of the agreed facts presented to the Court.

This is the second disqualification order obtained by the SFC. The SFC will continue to take action against directors who breach the trust given to them by shareholders, especially where they are involved in providing misleading information to the market.

In the same proceedings, the SFC sought disqualification orders against four other former directors of GP Nano. The hearing in respect of Chow Chun Kwong is scheduled for 30 January 2009; hearings in respect of the other three former directors have yet to be scheduled.

For further details, please refer to our press releases dated 30 March 2007, 30 May 2007 and 4 December 2008, and the judgment dated 27 November 2008 (HCMP 2524/2006) on the Judiciary website (www.judiciary.gov.hk).

Unfair treatment of clients penalised

The obligation under the Code of Conduct for Persons Licensed by or Registered with the SFC (Code of Conduct) to treat clients fairly is an important obligation.

The SFC recently issued a reprimand to Standard Chartered Bank (Hong Kong) Ltd (SCB) for failing to act in the best interests of its clients and to exercise due skill, care and diligence to reasonably ensure that its clients who invested in mutual funds from two fund houses were treated fairly.

The Hong Kong Monetary Authority, who conducted the investigation of SCB's behaviour, found that it allowed one client to obtain same-day pricing for switching in and out of the relevant mutual funds. This same day pricing arrangement was not made known, nor was it made available to other clients of the bank, who received next-day pricing.

The SFC disciplinary proceedings were resolved by way of agreement, the terms of which included a payment scheme under which approximately 1,260 SCB clients who invested in the relevant funds will be eligible to receive a share of a sum of around US$320,000.

For further information about this case, please refer to our press release dated 6 January 2009.

Systems to identify conflicts of interest

The SFC issued a reprimand to Deutsche Securities Asia Ltd (DSAL) and fined it $6 million. An SFC investigation into DSAL's services provided to institutional clients through its facilitation trading desk found that, from May 2001 to 30 September 2005, DSAL failed to:

- put in place an adequate system to identify and resolve potential conflicts of interest arising from commingled proprietary and client trades executed by the facilitation trading desk;
- maintain an appropriate and effective compliance function to detect and manage the risks to clients involved in dealing with clients as principal; and
- keep adequate audit trails of client order instructions.

Facilitation trading involves brokers and clients executing transactions on a principal-to-principal basis rather than on an agency basis. Facilitation trading can give advantages to clients by providing them with liquidity and more certain execution. As the nature of the relationship with a client may change in a facilitation (because the broker is no longer an agent but dealing with the client as principal), conflicts of interest may arise. Therefore, brokers offering facilitation services need systems in place to identify, manage and control any conflicts that may arise in the provision of facilitation services.

It is important that brokers offering facilitation services ensure their systems effectively record that the client involved knows the transaction is not a normal agency trade and that the execution of the order as a proprietary or agency order is clear.

For further details, please refer to our press release dated 16 December 2008.

District Court to judge market manipulation case

Criminal proceedings have been commenced against Patrick Fu Kor Kuen (Fu) and Francis Lee Shu Yuen (Lee). It is alleged that Fu and Lee undertook manipulative trading in various listed derivative warrants issued by Macquarie Bank Ltd. The SFC alleges that they had bought and sold the derivative warrants between themselves in approximately the same quantities and prices repeatedly, with the result that turnover in the warrants was artificially manipulated by over $450 million.

The two defendants were charged with 40 counts under section 295 of the SFO for creating a false and misleading appearance of active trading in derivative warrants between January 2004 and January 2005.

On 6 November 2008, the Eastern Magistracy granted the application by the Department of Justice to transfer the case to the District Court. The defendants will appear in the District Court for a pre-trial review on 11 February 2009.

For further information, please refer to our press release dated 6 November 2008

SFAT criticizes brokerage for 'sloppy and wholly negligent behaviour'

The Securities and Futures Appeals Tribunal (SFAT) has upheld a decision of the SFC to reprimand and fine Chung Nam Securities Ltd (Chung Nam) and Henry Chuang Yueheng (Chuang). The disciplinary action stemmed from an unauthorised withdrawal of more than $30 million in client securities held by Chung Nam.

The SFC found that Chuang had no official position or responsibility within Chung Nam for client securities or settlement but he was allowed to initiate the withdrawal process. Chuang said that he was instructed over the phone by a woman, who claimed to be representing a corporate client, to withdraw all securities in the corporate account. Later, a man purporting to represent the corporate client went to Chung Nam's office to see Chuang who handed over the physical scrip of the securities to him. Chuang did not request the man to produce any letter of authorisation; nor did he make any call to check whether the corporate client was aware of the withdrawal. Chung Nam's procedures did not require verification of identity or authority of persons giving instructions or collecting the securities. In fact, the corporate client never authorised the withdrawal of securities. However, the client did not suffer any loss as the securities were later recovered.

The SFC concluded that Chung Nam had failed to institute proper or sufficient systems to safeguard client assets and failed to establish an effective procedure for ensuring client securities are protected from misappropriation. While not finding Chuang or Chung Nam dishonest in relation to the misappropriation of the $30 million in securities, the SFC did find them grossly negligent.

The SFAT confirmed the SFC's findings and said that *"... sloppy and wholly negligent behaviour, of the type as has been evidenced in this case, as to the safeguarding of client assets will not be tolerated and is not regarded as acceptable"*.

Both appellants argued that the SFC's penalty was too harsh, and the SFAT reduced the amount of the penalty imposed on Chung Nam from $1 million to $750,000 and on Chuang from $500,000 to $350,000. They have lodged an appeal against the SFAT's decision to the Court of Appeal. The appeal has not yet been determined .

The SFC views failures to account for and safeguard client assets most seriously. Firms that fail to have adequate procedures in place to ensure the safeguarding of client assets should expect to face disciplinary action.

For further information, please refer to our press release dated 12 November 2008.

SFC disciplines three sponsor representatives

The SFAT has upheld the SFC's decisions to fine Eric Chan Shun Kuen (Chan) and Robin Jonathan Gibbs Fox (Fox), who failed to:

- reasonably ensure that representations made on behalf of the listing applicant to the SEHK were true, accurate, complete and not misleading in a material aspect;
- carry out adequate due diligence on the listing applicant; and
- supervise properly the listing applicant and the sponsorship team.

The disciplinary actions followed an SFC investigation into an application for listing on the GEM of a Mainland company. The listing application was ultimately rejected by SEHK.

Chan and Fox both worked on the sponsorship at the time. Chan was the assistant supervisor of the listing application and Fox signed off some replies to the SEHK's enquiries about the application when Chan was unavailable.

Both Chan and Fox filed applications with the SFAT to review the decisions the SFC imposed earlier. The SFAT found no merit in Chan's application and confirmed the SFC's decision to fine him $200,000. As for Fox, the SFAT accepted that he did not occupy any central role or responsibilities, but that he was not "wholly out of the loop". Given the difference in the levels of responsibilities between Chan and Fox, the SFAT determined that there should be "just and equitable disparity" in the fines imposed. The SFAT therefore reduced the fine imposed on Fox from $70,000 to $40,000.

In another case, the SFC prohibited Kelvin Wu King Shiu from re-entering the industry for two years and six months for failing to exercise proper supervision in handling a transfer listing application to the main board of the SEHK from the GEM.

Individuals charged with sponsor responsibilities are reminded to adhere to the Corporate Finance Adviser Code of Conduct and the Code of Conduct. It is the duty of the sponsor to make reasonably full disclosure and to exercise proper supervision in handling a listing application, as the purpose of due diligence is to ensure that the listing applicant is a viable company and potential investors are provided with material information to enable them to make an informed decision as to whether or not to invest in the listed company.

For further information, please refer to our press releases dated 3 December 2008 and 5 January 2009.

Enforcement policy and practice: tighter control urged over sub-account dealing

The SFC recently completed inquiries into the trading of certain warrants. During the course of these inquiries, we became concerned about the way in which some firms allowed their clients to operate sub-accounts.

In one case, we found that a client was allowed to open one master account and to operate more than 10 sub-accounts under the same master account . The client authorised different persons to conduct trading through the different sub-accounts. These authorised persons were each assigned with a user ID and password for entering orders into the firm's trading terminal directly. As different authorised persons placed orders for the same warrant at around the same time through two or more of the sub-accounts, the client bought and sold the same warrant. The orders resulted in transactions that involved no change in beneficial ownership and raised suspicions as to whether the orders were placed with a view to creating a false or misleading appearance of active trading in the warrants involved. The SFC considers that the self-matching of orders stemmed from the lack of control over the use of the sub-accounts.

Firms are required to have adequate and effective internal control systems in place to ensure compliance with the applicable law, rules, regulations and codes, as required by paragraph 12.1 of the Code of Conduct. This includes taking steps to ensure that the self-matching of orders, which may create a false market and is prejudicial to the integrity of the market, does not occur.

Therefore, firms should:

- establish and implement systems for circumstances where more than one authorised person is permitted to enter orders into a terminal for different sub-accounts;
- establish and implement systems to identify potentially manipulative or suspicious trades where sub-accounts are created/ used, such as installing appropriate parameters or alerts in systems, and generating reports in the event that such trades occur; and
- intervene in the event of potentially manipulative or suspicious trades, investigate and follow up in respect of any reports generated in this regard and review all the trades periodically during the day.

Disclosure of interests urged

The SFC continues to attach importance to the obligation of directors and substantial shareholders to make timely disclosure of their interests in listed companies.

Under Part XV of the SFO, listed company directors, chief executives and substantial shareholders are required to disclose and notify their company and the SEHK of changes in their interests.

From 2 October to 31 December 2008, the SFC prosecuted one entity for breaches in disclosure of interests. In this case, the defendant pleaded guilty and a fine of $10,000 was imposed.

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

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

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Securities and Futures Commission, 8/F Chater House,
8 Connaught Road Central, Hong Kong

Phone : (852) 2840 9222 Fax : (852) 2521 7836

SFC website : www.sfc.hk Media : (852) 2842 7717

InvestEd website : www.InvestEd.hk E-mail : enquiry@sfc.hk