Sidley Austin Hong Kong is pleased to distribute the third edition of its “Hong Kong Regulatory” newsletter. This publication provides updates on the latest developments in regulation of the Hong Kong financial markets, analysis of current enforcement trends and new laws/regulations, as well as practical tips for market participants.

In this edition, we examine the new (and stricter) era of regulatory reforms targeting listed corporations stemming from the increased emphasis on listed entity disclosures, the increased accountability of corporate directors and the government-led proposals to introduce a new regulatory oversight for listed entity auditors. We also discuss the sterner regulatory philosophy recently unveiled by the Market Misconduct Tribunal (MMT) to deter market misconduct.

FEATURE ARTICLES

INCREASED ACCOUNTABILITY FOR DIRECTORS/OFFICERS OF LISTED ENTITIES

A new statutory obligation to disclose inside information under Part XIVA of the Securities and Futures Ordinance (SFO) has been in effect since January 2013. It imposes personal liability on directors/officers of licensed corporations to disclose in layman terms important information to the market—otherwise known as PSI, or price sensitive information.

In defining what information should be disclosed, the SFO adopts the definition of “relevant information” currently used to prosecute insider dealing cases and has renamed it “inside information.” To assist market participants comply with the new rules, the SFO’s newly established Corporate Disclosure Team has set up a dedicated hotline to answer enquiries, subject to the caveat that views expressed by the Securities and Futures Commission (SFC) are preliminary and non-binding in nature. Failure to comply with the new disclosure obligations attracts a fine (capped at HK$8 million) as well as compensation orders in favor of affected investors. This new statutory obligation dovetails well with the existing duty to avoid false or misleading information under section 277 of the SFO.

Nevertheless, there remains a fair degree of uncertainty about what information should be disclosed, and these are often matters that will require legal advice. The SFC has publicly stated that it is no defense to delay timely disclosure of material information pending legal advice. To date, the SFC has not held directors/officers of licensed corporations personally accountable for breaches of the new statutory disclosure regime. Instead, the SFC has continued to rely on its pre-existing powers to impose disqualification orders on delinquent directors/officers and, in some instances, has intervened to appoint provisional liquidators (PLs) to relieve management of control of listed corporations.

• In March 2014, the SFC commenced disqualification proceedings against four former directors of Tack Fat Group International Limited, a clothing retailer in the P.R.C. Among those is the former chairman, who has since been disqualified for six years for failing to comply with the disclosure requirements under the listing rules. The case against the remaining three former directors is ongoing.

• In April 2014, the SFC used its power under section 213 of the SFO to freeze (on an interim basis) approximately HK$1.9 billion worth of
assets and appoint interim receivers and managers over Qunxing Paper Holdings Company Limited, a wallpaper manufacturer alleged to have materially overstated turnover in its annual results, now in liquidation in the P.R.C. The case is ongoing.

- In November 2014, the SFC obtained extensions of interim orders freezing assets up to the value of HK$1.2 billion against the former chairman and directors of Greencool Technology Holdings Limited for alleged disclosure of false and/or misleading information relating to its audited financial statements, pending the outcome of MMT proceedings (see below).

- In January 2015, following a contested trial, the SFC commenced disqualification proceedings and secured orders compelling three current and former directors of First China Financial Network Holdings Ltd., a brokerage firm, to pay nearly RMB18.7 million by way of compensation for issuing a public announcement overstating the consideration price payable after completion of the acquisition of another entity controlled by the chairman. Further hearings are scheduled to take place to determine the length of disqualification orders to be made consequent upon the findings of misconduct.

- In March 2015, following the appointment of PLs, the SFC wound up China Metal Recycling (Holdings) Limited, a scrap metal recycler, alleged to have published fictitious/inflated sales revenues and failed to publish a clarification announcement in compliance with conditions to resume trading. The case was the first public interest petition issued by the SFC to wind up a company listed in Hong Kong.

Going forward, the most important regulatory development in this area is the proposed enactment of a new regulatory regime to increase oversight of the work conducted by auditors of listed corporations, expected to be introduced later in 2015.

Under the proposed new regime, the powers to investigate audit engagements with listed entities will be transferred to the Financial Reporting Council (FRC). The FRC will be vested with powers broadly identical to the SFC’s to take enforcement action and discipline auditors, including the ability to exercise coercive powers to compel the production of audit working papers, and documents relating to accounting irregularities that should have been disclosed to the market. There will also be a power to conduct inspections of quality control policies and procedures of listed company audit engagements.

To date, there has been a mixed response from the accountancy bodies in Hong Kong. Notably, the Hong Kong Business Accountants Association has commented in its response to a Consultation Paper published by the Financial Services and Treasury Bureau in June 2014 that this new regime will not only create another layer of regulatory oversight, but will also impose an unnecessary additional burden upon listed entities and their auditors.
MMT SIGNALS A (NEW) STERNER APPROACH TO DETERRING MARKET MISCONDUCT

Our article titled “Is HK’s MMT Set for a More Prominent Role,” IFLR, January 24, 2014 (print and online editions) discussed what we had viewed as a more prominent role for the MMT since the recent reforms enabling the SFC to bring cases of suspected market misconduct without having to make a referral to the Financial Secretary. We also anticipated 2015 would likely see a resurgence in caseloads under an expanded MMT regime that now catches disclosures of price sensitive information. Since then, in line with our expectations, the SFC has directly instituted no less than six cases before the MMT (compared to the 10 cases it concluded in the past 10 years):

- First, against the Tiger Asia¹ parties for alleged insider dealing following the landmark ruling in the Court of Final Appeal which confirmed the free-standing civil jurisdiction to obtain remedial orders under section 213 of the SFO without a prior finding of misconduct by a criminal court or the MMT. The case was subsequently settled.
- Second, against members of senior management of Asia Telemedia Limited (renamed Reorient Group Limited) for alleged insider dealing. The case was adjourned part-heard in January 2015 and resumed in March 2015.
- Third, against the former chairman and chief executive officer of Greencool Technology Holdings Limited for alleged disclosure of false and/or misleading information pertaining to its financial statements. Substantive hearings have been fixed to take place in the last quarter of 2015.
- Fourth, against the former CEO and substantial shareholder of Water Oasis Group Limited for alleged insider dealing. The case was concluded in January 2015 and the MMT handed down its decision in early February 2015.
- Fifth, against the former chairman and executive directors of Citic Limited (formerly known as Citic Pacific Limited) for alleged disclosure of false and/or misleading information in failing to disclose a material adverse change in the financial position of Citic. The case is fixed for hearing in the last quarter of 2015. (A recent application for leave to overturn the SFC’s decision to institute the proceedings before the MMT against one of Citic’s former directors was dismissed in early 2015.)
- Last, against a research analyst (Citron Research) for alleged disclosure of false and/or misleading


CONTINUED ON PAGE 4
information in publishing a report relating to one of the 10 largest real estate developers in Mainland China. Substantive hearings have been fixed to take place in February 2016.

Each of these cases underscores a new regulatory philosophy, which is to take action against persons suspected of market misconduct, especially those against whom the SFC does not ordinarily have jurisdiction to pursue conventional civil, criminal or even disciplinary proceedings. In each case, the referral to the MMT arguably satisfies the SFC’s regulatory objectives to protect the investing public and deter market misconduct. To date, only two cases referred by the SFC directly to the MMT have concluded, namely Tiger Asia and Water Oasis, but each of these emphasizes the need to balance the range of orders sought to be imposed against the likelihood or threat of reoffending as discussed below.

In Tiger Asia, the MMT stressed that cold-shoulder orders and cease and desist orders were “not mutually exclusive” but, being protective in nature, would only be imposed “when, in the view of the Tribunal, there is a requirement for protection.” Adopting this approach, the MMT concluded that no purpose would be served in imposing such orders when the relevant person could no longer play a role in the markets. That was the position here, where medical evidence was adduced to show that a specified person had suffered brain damage as a result of a severe stroke. Despite the admission of market misconduct by the other parties, the MMT went on to impose a four-year cold-shoulder order and added that market participants (be they corporations or individuals) “who, by their actions, show they cannot be trusted must from now on expect orders that exclude them from the market for more lengthy periods of time.” In doing so, the MMT itself acknowledged that this “heralds a sterner approach in respect of protective measures provided under [the SFO].”

In Water Oasis, medical evidence was adduced to establish that the specified person (the former CEO and substantial shareholder) was suffering from an undiagnosed psychiatric illness, which very substantially reduced her culpability, when disposing of 0.94 percent of her total shareholding shortly after being informed that a material contract which accounted for more than 20 percent of the company’s net profits had been terminated. The MMT found that stress or psychiatric disorders associated with news that a company’s finances are more dire than anticipated and that directly threaten a person’s stakeholding, which may perhaps be the main basis of their wealth, “cannot excuse market misconduct even though it may perhaps mitigate culpability.” In light of these findings, the MMT concluded that a two-year disqualification order was sufficient and declined to impose any further orders, as the CEO had since removed herself from any direct involvement in the commercial world and no longer posed a threat. No purpose would therefore be served in imposing a cold-shoulder or cease and desist order. The MMT noted “[i]f it may be said that every person who is guilty of market misconduct cannot be trusted to operate in our markets in accordance with the requirements of law,” but cautioned that “if that principle is to be rigidly applied, it would mean that every person found guilty would be subject to the sanction and that itself, in the view of the Tribunal, would bring the Tribunal perilously close to imposing the prohibition by way of a penalty rather than a protective order.”

These recent decisions illustrate that the MMT is willing to adopt a degree of flexibility to ensure that only orders necessary for the protection of the market are imposed. However, it remains to be seen what (if any) discount or leniency will be afforded by the MMT to parties who admit culpability in future cases. This is particularly notable in light of the MMT’s stance of adopting a sterner approach in sanctioning misconduct. This stricter approach, viewed in conjunction with the SFC’s reluctance to tailor sanctions for suspected misconduct, may persuade parties to contest more cases of alleged misconduct.

2. A cold-shoulder order imposes a prohibition on an identified person from dealing for a specified time; a cease and desist order permits dealing subject, but serves as a reminder at all times to do so lawfully.
3. See the MMT’s decision in Water Oasis Group Limited dated February 5, 2015 (Chairman sitting alone).
Sponsor Liability

- **May 2014:** an IPO sponsor was reprimanded and fined HK$12.5 million for failing to verify the places and using excessive top-up margin financing to satisfy public float requirements.
- **September 2014:** the SFC suspended responsible officers at another IPO sponsor for placing undue reliance on work delegated to external experts.

Internal Control Failures

- **April 2014:** a registered institution was reprimanded and fined HK$6 million for failing to detect unauthorized trading activities by a rogue trader. The SFC noted that the institution avoided a stiffer penalty by self-reporting the misconduct promptly.
- **May 2014:** a further licensed corporation was reprimanded for internal control deficiencies relating to certain trades using its algo trading system. The SFC noted that a heavy fine would have been imposed if the failures occurred after January 1, 2014, when the new electronic trading regime came into effect.
- **February 2015:** the former CEO of a HK-based securities broker was banned for 12 months for inadequate AML procedures. The SFC noted that it will hold senior management accountable where they are involved and responsible for internal control deficiencies. A related disciplinary proceeding against another member of the staff is also pending before the Securities and Futures Appeals Tribunal (SFAT).
- **April 2015** and **June 2015:** the securities trading arm of two investment banks were respectively reprimanded and fined HK$2 million for internal control failures involving position limits and HK$11 million for failing to report cross trades to the Hong Kong Stock Exchange.

Life Bans

Life bans were imposed on 10 more licensed representatives:

- Seven life bans were imposed for misappropriation of client assets or fraud involving sums ranging from HK$400,000 up to HK$28 million.
- Two bans were imposed for breach of fit and proper requirements by (i) an equity derivatives trader who manipulated orders and booked fictitious trades to hide losses in his trading book exceeding US$5 million and (ii) a futures trader who provided false information to clients to conceal trading losses exceeding HK$8 million in their accounts.
- One ban followed breaches of liquid capital requirements and the submission of false and misleading financial returns.

Licensing Related Issues

- **May 2014:** a HK-based securities broker was reprimanded and fined HK$1.7 million by the SFC for conducting illegal cross-border securities activities in Macau. The Monetary Authority of Macau had earlier fined the broker MOP$1.5 million.
- **March 2015:** in a landmark ruling, the Court of Final Appeal disapproved of the SFC’s interpretation of section 103(3)(k) of the SFO, which requires SFC authorization of any advertisement to acquire interests in a collective investment scheme (CIS) unless disposed of only to professional investors (PIs). The CFA held that the advertisement did not have to actually state that the relevant product was intended for PIs provided it was only disposed to PIs. The screening process carried out by the defendants to ensure that only PIs could subscribe to the product was sufficient to establish the statutory defense under s103(3)(k). The SFC has conceded that the criminal convictions of both the HK-based asset manager and its director for issuing unauthorized advertisements in respect of a CIS ought to be reversed but is considering whether it should seek to amend the legislation.

SFAT Confirms Proceedings Are Open to The Public

- **December 2014:** SFAT ruled that appeals against disciplinary decisions made by the SFC are to be conducted in public. Fears of professional embarrassment and possible damage to the professional reputation of the licensed persons/intermediaries who contest SFC decisions did not justify a restriction on the open administration of justice.