

# SFC Enforcement Trends

February 2020

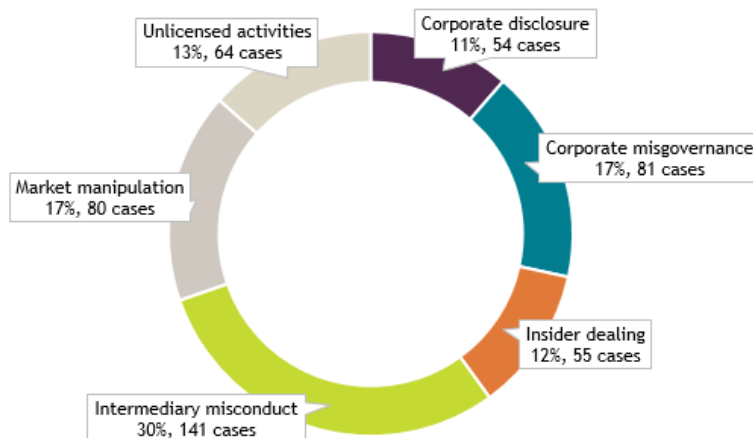
As we welcome the year of the rat, it is useful to review the enforcement activities of the Securities and Futures Commission (SFC) in the past year, as well as project the upcoming focuses and priorities of the SFC. The SFC concluded a number of high profile sponsor misconduct cases in the past year. A record fine of HK\$813.7 million was imposed on five sponsor firms who acted as sponsors in the listing applications of three companies. Other enforcement priorities of the SFC during 2019 include corporate fraud and misgovernance, market misconduct, late disclosure of inside information, and intermediary

misconduct and internal control failures. It is expected that these will remain the enforcement focuses of the SFC in 2020. We also expect to see more joint operations between the SFC and the Independent Commission Against Corruption (ICAC), as well as possible enforcement actions under the Manager-In-Charge regime.

## Enforcement statistics at a glance

A breakdown of the ongoing investigations by the SFC by nature during the quarter ended 30 September 2019 is as follows<sup>1</sup>:

Breakdown of ongoing investigations by the SFC for the quarter ended 30 September 2019 (475 cases in total)



<sup>1</sup> <https://www.sfc.hk/web/EN/regulatory-functions/enforcement/enforcement-statistics/active-investigations-by-case-nature.html>. As at the date of this

briefing, enforcement statistics for the quarter ended 31 December 2019 were not yet available.

## Conclusion of high profile sponsor misconduct cases

Sponsor misconduct has been a focus of the SFC for a number of years and 2019 saw the conclusion of a number of high profile sponsor misconduct cases involving prominent financial institutions. A total of five sponsor firms were fined a total of HK\$813.7 million for their failure, in the late 2000s and early 2010s, to conduct proper due diligence on three listing applicants, China Forestry Holdings Company Limited (**China Forestry**), Tianhe Chemicals Group Limited (**Tianhe Chemicals**) and China Metal Recycling (Holdings) Limited (**China Metal**). One particular sponsor firm was fined HK\$375 million for failing, in all three listing applications, to discharge their obligation as one of the joint sponsors. Its license to advise on corporate finance was also partially suspended for a year, as a result of which the sponsor firm could not act as sponsor for any listing application on the Stock Exchange of Hong Kong Limited (**SEHK**) for a year<sup>2</sup>.

Sponsor due diligence failings uncovered in these cases include:

- (i) Failure to verify key assets of the listing applicant;
- (ii) Failure to identify and follow up on apparent discrepancies and inconsistencies in the materials provided for due diligence;
- (iii) Failure to confirm the bona fides of the interviewees, including establishing their identity and ascertaining their authority and knowledge;

- (iv) Failure to act and follow up on obvious red flags and irregularities;
- (v) Failure to apply professional scepticism and verify information/representation provided/made by the listing applicant;
- (vi) Inadequate due diligence on areas such as customers, suppliers and third party payments; and
- (vii) Allowing the listing applicant to control the due diligence process, such as allowing the applicant to dictate due diligence interview arrangements.

In addition to sanctioning the sponsor firms who had performed substandard due diligence work, the SFC also disciplined three (then) IPO sponsor principals for failing to properly supervise the execution of the respective listing applications. The SFC suspended the licence of these sponsor principals for 18 months to three years respectively.

While the disciplinary actions against intermediaries involved in the listing of China Forestry, Tianhe Chemicals and China Metal came to a close in 2019, certain enforcement actions against former executives of these companies remain on foot. In particular, the SFC has brought proceedings in both the Market Misconduct Tribunal (**MMT Proceedings**) and the Court of First Instance (**CFI Proceedings**) against the former Chairman and CEO of China Forestry for suspected disclosure of false or misleading information in China Forestry's IPO prospectus and annual and interim reports which induced transactions in the shares of China Forestry. The MMT Proceedings will soon conclude and a decision is expected to be rendered in the first half of 2020. This is

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<sup>2</sup> The suspension on the sponsor firm concerned was recently lifted (see our [January 2020 Client Briefing](#) for more details).

expected to be followed by the continuation of the CFI Proceedings which will seek to restore victims to the position they were in before they traded in China Forestry shares.

### **Continued focus on corporate fraud, market misconduct, and intermediary misconduct**

Corporate fraud remained one of the priorities of the SFC in 2019 and is expected to remain so going forward. Apart from continuing the MMT Proceedings and CFI Proceedings against former executives of China Forestry, the SFC also sought disqualification orders and compensation orders against senior executives of a number of listed companies, who have allegedly perpetrated fraud on their companies and/or shareholders.

In the past year, the SFC also continued to pursue market misconduct cases such as insider dealing and market manipulation with full rigour. This included the conviction and sentencing, during 2019, of a former staff of Hong Kong Television Network Limited, and a former group finance manager of China CBM Group Company Limited, for insider dealing offences. During the year, the SFC also commenced MMT proceedings against the former chairman and executive director of Meadville Holdings Limited, and commenced criminal proceedings against a practising solicitor for allegedly insider dealing in the shares of CASH Financial Services Group Limited.

In respect of late disclosure of inside information, the SFC commenced MMT proceedings in October 2019 against China Medical & Healthcare Group Limited and its senior management for allegedly failing to disclose significant gains made by the company in securities trading as soon as reasonably practicable in 2014. During 2019, the MMT also fined Health and Happiness (H&H)

International Holdings Ltd and its Chairman HK\$3.2 million in total, and Fujikon Industrial Holdings Limited, its CEO and CFO HK\$1.5 million in total for late disclosure of inside information<sup>3</sup>.

The SFC also continued to monitor intermediaries' compliance with (and take disciplinary actions where it suspects a breach of) rules and regulations applicable to these intermediaries, such as the Code of Conduct for Persons Licensed by or Registered with the SFC, the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC, and anti-money laundering legislation and guidelines. Notably, Guosen Securities (HK) Brokerage Company, Limited was fined HK\$15.2 million for breaches of AML regulatory requirements, and UBS AG was fined HK\$400 million for overcharging clients over a ten year period and for related systemic internal control failures. With the Manager-In-Charge regime (details of which see below) having been fully implemented, it is expected that intermediary misconduct will be scrutinised not only at the level of corporations, but also at the level of individuals, whose action/inaction contributed to the unsatisfactory state of affairs of the licensed corporation.

### **Increased focus on individual accountability**

Corporations can only act through individuals. Therefore, establishing individual accountability within corporations and identifying and eradicating “bad apples” are crucial in curbing corporate misconduct.

The SFC has implemented the Manager-In-Charge (MIC) regime in late 2017, under which licensed corporations are required to appoint an individual to be principally responsible for managing each of

<sup>3</sup> See our [March 2019 Client Briefing](#) for a highlight of the disclosure of inside information regime under Part XIVA of

the Securities and Futures Ordinance and key cases under the regime.

the eight “core functions” of the licensed corporation, and report these designations and any change to the same to the SFC. As of January 2020, there is yet to be an enforcement action against a MIC of a licensed corporation. However, Ms Julia Leung (**Ms Leung**), the Deputy CEO of the SFC and the Executive Director of the Intermediaries Division, noted in the SFC’s Compliance Forum in June 2019 that the MIC regime is one of the SFC’s current supervisory priorities, which allows the SFC to quickly identify “*who could be held accountable for control failures or conduct issues*”. Therefore, the first enforcement action under the MIC regime may be forthcoming.

In terms of identifying and eradicating “bad apples”, in April 2019, the SFC introduced the requirement that a licensed corporation should disclose information about any investigation it has commenced against a licensed individual who ceases to be accredited to it. This requirement is aimed at stopping licensed representatives engaged in misconduct (bad apples) who resigned from their original employer from “rolling” onto the next licensed corporation without being detected (please see our [May 2019 Client Briefing](#) for more details).

### Strengthening cooperation with local and international authorities

In the past year, the SFC also further strengthened cooperation with both local and international authorities. Notably, the SFC entered into a tri-partite Memorandum of Understanding (**Tri-partite MoU**) in July 2019 on audit working papers with the Ministry of Finance of the People’s Republic of China (**MOF**) and the China Securities Regulatory Commission (**CSRC**).

Under the Tri-partite MoU, the MOF and CSRC will provide the fullest assistance in response to the SFC’s request for audit working papers of a Hong Kong listed Mainland company prepared by Hong Kong accounting firms but kept in the Mainland (please see our [July 2019 Client Briefing](#) for more details).

Locally, the SFC entered into a Memorandum of Understanding with the ICAC in August 2019 (**SFC ICAC MoU**) to formalise and strengthen cooperation of the two authorities. The SFC ICAC MoU covers referral of cases, joint investigations, exchange and use of information, mutual provision of investigative assistance and capacity building. In 2019, the cooperation of the two authorities culminated in the charging of former executives and senior management of Convey Global Holdings Limited (**Convoy Global**) for conspiracy to defraud the SEHK, Convoy Global and its board of directors and shareholders. With the SFC ICAC MoU, joint operation of this kind is expected to be more prevalent in 2020 and beyond.

### New regulatory framework in respect of virtual assets

Fintech and virtual assets have been an emerging focus of the SFC for the past few years, in line with the direction of the International Organization of Securities Commissions (**IOSCO**)<sup>4</sup>. In November 2019, the SFC introduced a new regulatory framework for virtual asset trading platforms. This new regime operates on an opt-in basis, whereby virtual asset trading platforms can elect to be licensed and regulated by the SFC by offering at least one security token on its

<sup>4</sup> Crypto-asset has been identified as one of the priority issues by the IOSCO for 2019 and 2020 respectively. See Board Priorities - IOSCO work program for 2019 and 2020 respectively (accessible at <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD648.pdf>)

df and <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD625.pdf>).

platform<sup>5</sup>. These operators are then required to apply for a license for Type 1 (dealing in securities) and Type 7 (providing automated trading services) regulated activities. The new framework addresses key investor protection areas in respect of trading in virtual assets, including the safe custody of assets, know-your-client requirements, anti-money laundering and market manipulation. This is achieved by the imposition of licensing conditions and requiring compliance with prescribed terms and conditions for operating virtual asset trading platforms. The SFC has made it clear that any breach of a licensing condition under the framework would be considered “misconduct” under the SFO, which would subject the platform operator to disciplinary action by the SFC<sup>6</sup>.

The framework has just taken effect and the SFC has just begun to accept applications for license. Accordingly, it may be too early to see any enforcement action under the framework in the near future. However, this highlights that virtual assets will be an emerging focus of the SFC and that virtual assets trading will be increasingly scrutinised.

### Notable judicial decisions

The Court of First Instance (CFI) has very recently handed down a decision regarding the SFC’s investigative powers and how that interacts with subjects’ right to privacy under Article 30 of the Basic Law (BL 30) and Article 14 of the Hong Kong Bill of Rights (BOR 14)<sup>7</sup>. The CFI dismissed the Applicants’ application for judicial review of a number of search warrants and the decisions made by the SFC in executing those warrants. The Applicants alleged that the decisions of the SFC to

seize various digital devices belonging to the Applicants and retain them; as well as issue notices to require the Applicants to provide the passwords to their email accounts or digital devices were ultra vires the SFO or the warrants, unlawful and/or unconstitutional for interference with BL 30 and BOR 14. These were rejected by the Hon Chow J, who held that the right to privacy is not absolute, but may lawfully be restricted provided that the restriction can satisfy the 4-step proportionality test of (i) “legitimate aim”, (ii) “rational connection”, (iii) “no more than reasonably necessary”, and (iv) “fair balance”. It was held that due to the safeguards put in place by the SFC to seek to protect the privacy of the Applicants, including using keyword searches to identify relevant materials contained in or accessible through the digital devices and/or viewing the contents together with the Applicants so as to minimise the chance of interference with their right of privacy, the SFC’s decisions were no more than reasonably necessary and struck a fair balance between the interests of the SFC of maintaining market integrity and the privacy interests of the Applicants. The application for judicial review was dismissed.

An important judicial decision in 2019 concerning the Securities and Futures Ordinance (SFO) is the CFI’s decision in *AA & Anor v The Securities and Futures Commission* [2019] HKCFI 246 (Decision), in which the CFI dismissed a judicial review application brought by a licensed corporation and its responsible officer against the SFC in connection with the SFC’s investigation of suspected market manipulation in Japan listed shares. The Decision confirms the constitutionality of section 181 of the SFO by affirming that the section does not abrogate the

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<sup>5</sup> Virtual asset trading platforms which only trade non-security virtual assets or tokens will fall outside of the jurisdiction of the SFC, as virtual assets of this type are not “securities” or “futures contracts” under the SFO.

<sup>6</sup> Position paper - Regulation of virtual asset trading platforms dated 6 November 2019 published by the SFC.

<sup>7</sup> HCAL 2132, 2133, 2134, 2136 & 2137/2018; judgment dated 14 February 2020.

privilege against self-incrimination contrary to the Hong Kong Bill of Rights. A person in receipt of a section 181 notice may remain silent by asserting privilege against self-incrimination, which would constitute a “reasonable excuse” for non-compliance with the notice. However, circumstances where such privilege can be asserted are extremely limited, as, as a matter of principle, privilege does not apply to pre-existing materials that have an existence independent of the will of the recipient of the section 181 notice. Accordingly, securities transaction data obtainable pursuant to section 181 which were generated in the course of business and which came into existence prior to the section 181 notice are not privileged from production to the SFC (please see our [February 2019 Client Briefing](#) for more details).

### Looking forward

Although disciplinary action against a number of sponsor firms concluded in 2019, it should not be assumed that misconduct associated with the IPO process will be given a lower priority in 2020. In a speech given in late 2019, Ms Leung reiterated the major failings in sponsor due diligence work found by the SFC. She also noted a new focus of the SFC in connection with the IPO process - book

building by underwriters. Ms Leung commented that misconduct in the book building process (such as underwriters submitting inflated or fictitious orders) may damage the integrity of the market. The SFC is currently conducting a thematic review of the book building process and we can expect more scrutiny of the SFC and possible enforcement action in relation to this process in 2020 and beyond (please see our [October 2019 Client Briefing](#) for more details).

It is also expected that corporate fraud, market misconduct and intermediary misconduct will remain focuses of the SFC in the coming year. Also, as we are more than two years into the implementation of the MIC regime, the SFC may bring the first enforcement action under the regime in the near future. However, as the term of the current Chief Executive Officer of the SFC, Mr Ashley Alder, will come to an end in September 2020, the incoming Chief Executive may impact on the enforcement direction of the SFC. While the ethos of the SFC will not fundamentally change with such succession, new strategic initiatives may be introduced in due course which will have an impact on the activities of market participants.





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