STEPHENSON HARWOOD
罗 夏 信 律 师 事 务 所

Issue 1

Regulatory enforcement newsletter

Inside

Introduction

Failing to meet the exacting standards demanded by regulators and law enforcement can lead to very serious consequences for businesses and the individuals who work in them which include criminal prosecution, regulatory enforcement, disciplinary action, loss of reputation and livelihood, commercial and market damage, bad publicity, regulatory remediation exercises and civil claims.

In this newsletter prepared by Ian Childs, and those which will follow on a quarterly basis, we will update you about notable cases and trends in the regulatory litigation area where the fast pace of change continues unabated and levels of enforcement by the Securities and Futures Commission ("**SFC**") remain extremely high.

Whenever any interesting Hong Kong Police or Independent Commission Against Corruption matters arise, it is our intention to also feature those.

I hope that you will find this newsletter informative.

Thank you

Ian Childs

Senior associate

T: +852 2533 2884
E: ian.childs@shlegal.com

Part XIVA of the Securities and Futures Ordinance ("SFO")

With the intention of changing behaviour and enhancing market transparency, on 1 January 2013, Part XIVA of the SFO became law and thereafter required listed companies to disclose inside information as soon as reasonably practicable after it came to their knowledge.

The trigger for disclosure (section 307B SFO) being that the inside information has, or ought reasonably to have, come to the knowledge of an officer of the listed company in the course of them performing their functions as an officer, and, a reasonable person acting as an officer of the company would consider the information as inside information.

On 1 January 2013, the Market Misconduct Tribunal ("**MMT**"), an inquisitorial body established to police and regulate market behaviour, had its jurisdiction expanded to determine breaches of Part XIVA.

Four years down the road, we are now starting to see the SFC's first Part XIVA enforcement actions being decided by the MMT.

Below, we consider the MMT's decisions concerning:

(i) Yorkey Optical International (Cayman) Limited; and

(ii) Mayer Holdings Limited.

These decisions show what the SFC expects.

They are also a benchmark for everyone else, in particular those involved in the management of listed companies, to take very careful notice of.

Yorkey Optical International (Cayman) Limited ("Yorkey") – no profit warning, how **not** to comply with Part XIVA

On 28 February 2017, the MMT found that Yorkey, its CEO Nagai Michio and CFO Ng Chi Ching had each breached their statutory obligation to disclose inside information.

Facts

In its Interim Results for the first six months of 2012 (released 16 August 2012), Yorkey's revenue decreased compared to the same period in 2011 by 12.1%. Net profit had also fallen by 62%.

Nonetheless Yorkey stated that it expected significant growth and increasing profitability in the second half of the year.

No growth or profitability followed. In fact in the second half of 2012 Yorkey sustained material losses and its financial performance deteriorated significantly.

No profit warning was made and Yorkey did not tell the public that the company would not be achieving the significant growth and increased profitability it had stated was expected.

Yorkey announced its 2012 results on 25 March 2013 (after Part XIVA had become law) when the company reported:

(i) a loss before tax of US$136,000 (profit before tax was US$7.531 million in 2011); and

(ii) net profit (after tax credit) had declined by 99% from 2011. Yorkey's revenue and profitability had also decreased in the second half of 2012.

Yorkey's Share Price

In the 3 days after reporting its 2012 results, Yorkey's share price fell by 21.25% from HK$0.80 to HK$0.63 per share.

Investigation

The SFC found:

1. Yorkey prepared monthly management accounts which would be available in the middle of the next month for review by Mr Michio;
2. The monthly management accounts for October, November and December 2012 showed Yorkey incurring significant net losses for those months; and
3. In mid-January 2013, internal accounts for 2012 were available and passed to Mr Michio, so he was aware of the company's deteriorating performance by then at the latest.

Inside information

The MMT concluded that Yorkey's low turnover and losses contained in October to December 2012's monthly management accounts satisfied the definition of inside information (section 307A(1) SFO) being specific information relating to the company, not generally known to the public and which would materially affect Yorkey's share price.

Furthermore, the monthly results from July to November were sufficiently poor to indicate to management that 2012's results would be much worse than expected.

When disclosure of the inside information should have happened?

The MMT found that Mr Michio in performing his duties as CEO of Yorkey had (or ought reasonably to have) come to know of the company's deterioration by mid-January 2013 at the latest (when he had the monthly management accounts for December and 2012 internal accounts). At that point in time the obligation to disclose the inside information as soon as reasonably practicable existed and as stated above, that was breached because the public was not informed of Yorkey's poor performance until 25 March 2013 (two months later).

Mr Michio and Mr Ng, Yorkey's officers, breached section 307G of the SFO for failing to have taken all

reasonable measures to prevent the company from breaching its disclosure obligations. The MMT also found that both were aware of Yorkey's deterioration well before the company published its 2012 results (on 25 March 2013) and were reckless or negligent for failing to take any steps to ensure the disclosure of the information to the public. As a result, the MMT ordered:

- Yorkey and Mr Michio each pay a fine of HK$1 million;
- Mr Michio and Mr Ng be disqualified from being a director or involved in the management of a listed company for 18 and 15 months respectively. The SFC has recommended Mr Ng, an accountant, be disciplined by the HKICPA;
- The SFC's investigation and MMT costs be paid by Yorkey, Mr Michio and Mr Ng; and
- Yorkey's disclosure procedures be reviewed, Mr Michio and Mr Ng attend SFC approved training.

What next? Civil liability for Mr Michio and Mr Ng…

On the MMT's finding, section 307Z of the SFO imposes a statutory civil obligation on Mr Michio and Mr Ng to pay compensation to any person who has suffered a loss following their failure to make a timely disclosure of the inside information provided it is 'fair, just and reasonable'. On the face of it, such claimants would be the purchasers of Yorkey's shares after the disclosure obligation existed and who lost 21% in the value of their investments when the company's share price fell.

It will be interesting to see how this part of the law develops. The sting in the tail for Mr Michio and Mr Ng is most definitely the prospect of civil claims under section 307Z. However, they both may also have breached their duties to Yorkey entitling the company to bring a claim against them for the loss and damage it was caused.

Things for listcos and officers to note

The case illustrates how substantial fines and lengthy disqualification orders will be given. Listed companies and their officers need to be careful when reviewing internal management accounts and draft accounts and aware to disclose any unexpected loss (or profit).

Finally, officers need to bear section 307Z SFO in mind and the potential liability they may be subjected to on failing to make a disclosure when necessary and/or when not having put in place systems to bring such information to their attention.

Mayer Holdings Limited ("Mayer") – keeping quiet about the auditor's resignation, another example of how **not** to comply with Part XIVA

On 4 March 2016, the MMT was asked by the SFC to determine if the disclosure requirements of sections 307B and 307G of the SFO had been breached and to identify those responsible. In total, aside of Mayer, 10 officers of the company were before the MMT. '*Officer*' is defined widely in the SFO as a director, manager, secretary or anyone else involved in the company's management.

On 7 February 2017, the MMT found Mayer and all officers save one (who could not be served with the proceedings) in breach of the Part XIVA. On 5 April 2017, the MMT imposed heavy sanctions on them all.

Factual background

Mayer had been listed in 2004. Its shares had been suspended on 9 January 2012.

Tommy Chan Lai Yin ("**Chan**"), a qualified accountant was Mayer's financial controller and company secretary. Lai Yuet Hsing ("**Lai**") was an executive director and largely responsible for running Mayer's business with Chan.

The other officers before the MMT were all directors of Mayer, including one non-executive director ("**NED**").

Audit issues

Between April and August 2012, Grant Thornton (the "**Auditor**") had communicated repeated issues with Mayer's management about the company's 2011 financial statements ("**outstanding audit issues**"). The Auditor's report would be qualified if these issues weren't resolved. From September 2012, Mayer, its directors or audit committee avoided the issues.

On 27 December 2012, in a letter to Mayer's board and audit committee, the Auditor resigned with immediate effect. The letter reminded Mayer it needed to quickly publish an announcement about the resignation as required in the Listing Rules. In legal advice (on 31 December), a fax from the Stock Exchange (on 15 January) and reminders from the then ex-Auditor (on 16 January), Chan and Lai were reminded to make a public announcement.

No announcement was made: the directors were not even told about the Auditor's resignation until 18 January 2013.

Thereafter, Mayer's board only met on 23 January 2013 and an announcement about the Auditor's resignation was published on the same day.

MMT's decision

The MMT agreed with the SFC that each of the Auditor's resignation, the outstanding audit issues and unsecured and irrecoverable payments of US$14 million to a supplier were about Mayer, specific and generally not known and therefore inside information requiring public disclosure as soon as was reasonably practicable - which Mayer had failed to do in breach of section 307B SFO.

Auditors' resignation announcement

It was argued the suspension of Mayer's shares in early 2012 rendered any resignation announcement unnecessary.

However, section 307A(3) SFO mandates that shares 'are to continue to be regarded as listed during any period of suspension…', therefore Part XIVA continued to apply to Mayer.

The MMT found that public disclosure of this inside information should have happened within 1-2 days of legal advice about the resignation letter coming to Mayer's attention (such had happened when Chan was legally advised to make an announcement on 31 December 2012).

If Mayer disagreed with the Auditor's reasons they could have explained why in their announcement. It was unacceptable not to make the announcement and disclosure on 23 January 2013 by Mayer was unreasonable particularly in light of the multiple reminders Chan/Mayer had received (see above).

It was also argued Chan's disclosure of the resignation to the Stock Exchange discharged Mayer's obligations. This was rejected because it was not a disclosure that gave 'equal, timely and effective access to the public'.

As a matter of law, dissemination of inside information on the Stock Exchange's electronic publication system complies with the SFO.

Qualified audit and irrecoverable payments

The MMT found that:

- A qualified audit would be viewed negatively, cast serious doubt about a company's accounts and may even suggest fraud; and
- The amount of the prepayments to the supplier could exceed 10% of Mayer's shareholders' funds and might involve fraud,

therefore, as a result, this information should also have been disclosed by Mayer.

Directors' disclosure obligations

Chan, Lai and the other officers of Mayer were under a statutory duty to take all reasonable measures to ensure proper safeguards existed to prevent any breach of Mayer's disclosure obligations. In 2012/13 Mayer had no internal systems or written procedures in place to comply with Part XIVA. As a result, all the officers were in breach of section 307G SFO.

NED

The NED was only told of the resignation by Chan on 18 January 2013. Nonetheless, the MMT found the NED in breach of the SFO because of his failure to comply with section 307G and ensure proper safeguards existed to prevent Mayer's breach.

The MMT found it relevant that the NED had not complained about the lack of systems and policies (he might have had a defence if he'd done so).

Disqualification as a director or manager of a listed corporation

The maximum period of disqualification for directors breaching Part XIVA is 5 years (section 307N SFO). The MMT stated the most serious cases with repeat offenders could expect disqualifications for between 3.3 to 5 years. Serious cases but first offences would attract disqualification for 2 to 3.3 years. The least serious cases would attract disqualification for up to 2 years.

The MMT felt not disclosing the Auditor's resignation for 23 days warranted disqualification orders of 1 year for all the officers save Chan and Lai.

These officers had an inescapable personal liability to comply with Part XIVA and their, in particular the NED's, ignorance and incompetence was no excuse.

Chan and Lai deliberately flouted the disclosure regime. They knew a disclosure was needed but chose not to, concealing the Auditor's resignation from Mayer's board. The MMT found them to be unquestionably unfit to be a director of a listed company. They were both disqualified for 20 months.

Regulatory fines

Chan and Lai were each fined HK$1.5 million for their breaches. Mayer and the other officers were fined HK$900,000 (the maximum fine is HK$8 million).

Mayer and the NED pleaded they were in dire financial circumstances. The MMT dismissed this as a bare assertion. The MMT stated if a party wanted to raise their financial resources as a ground for a lower fine, full and frank disclosure of his financial position was needed. Neither Mayer nor the NED had done so.

Mayer and the officers were also ordered to pay costs.

Mitigation

While Mayer had admitted liability for breaching Part XIVA at the MMT hearing, it was held to be much too late to be a factor.

Finally

The MMT decided to recommend that Chan be disciplined by the HKICPA. It was stated accountants had an important role in the listing regime and are relied on by the public for their expertise in audit and compliance. Chan's conduct was stated to be appalling in ignoring the Stock Exchange's and Mayer's solicitor's advice.

Hong Kong Courts change their practice to do the '*fullest justice*' for victims of fraud

In an earlier litigation bulletin, we advised clients what to do if they had been defrauded. This article explains how Hong Kong's courts are also doing their part to help victims out.

The problem

Sadly, there are all too many cases these days where crimes committed abroad see the proceeds transferred to Hong Kong bank accounts. No doubt, with Hong Kong being a reputable financial centre, an instruction to remit money here does not raise any alarm with the victim. Typically, the proceeds will only be in the jurisdiction for a short period of time before being moved off shore and lost.

We are frequently instructed to help trace, restrain and recover victim's money and have recently acted following crimes committed in America, England, Ireland, Nigeria, Mali, Singapore, Sweden and Switzerland. The most common type of fraud entails a fake or hacked email being sent to the victim with bogus payment instructions.

Once a payment is made, time is then very much of the essence. It is a race to locate the funds and restrain them before they disappear. It is then necessary to quickly obtain a judgment and enforce it. The victim, even if pursuing a proprietary or ownership claim, faces many risks. One of which is that other creditors may make a claim against the owner of the bank account. This can then deny the victim any recovery (because other creditors have already taken everything): this is the particular issue which the Hong Kong Courts have tried to resolve.

Declaration of trust

In our experience, the owner of the bank account which the funds were remitted to is often a recently incorporated private company with its director and shareholder offshore. When sued they usually do not make an appearance to contest the claim. Until a recent sequence of High Court judgments (including DHCJ Cooney SC's judgment in Guaranty and Trust Company v ZZZIK Inc Limited & Anor, HCA 1139/2016) the absence of the owner of the bank account has caused injustice.

With no-one defending the claim there is no trial and without, the court was reluctant to grant declaratory relief. Victims would seek declarations that the funds in the Hong Kong bank account were held on trust for them. The point would not be determined in default proceedings instead, the victim would obtain a monetary judgment on default and would only become an unsecured judgment creditor with no prior or specific rights over the funds in the bank account.

Making a declaration in the absence of the defendant

In the ZZZIK Inc case, DHCJ Cooney SC stated 'it is not the normal practice of the court to make a declaration

without a trial. … this is a rule of practice and not a rule of law.' Taking account that the paramount duty of the court is to do the fullest justice for the victim, he decided when a genuine need existed declaratory relief can be granted in the absence of the defendant.

When is there a '*genuine need*'?

DHCJ Cooney SC stated the necessary need existed when:

- The defendant bank account holder receives funds obtained by fraud.
- The victim makes a proprietary claim for the funds traced into the defendant's bank account.
- A victim is at risk should other creditors appear.

A declaration by the court that the funds are the victim's will earmark them as their property and put them out of the reach of the any other creditors. This approach is obviously a welcome change. Victims of fraud can safe guard their property at an early stage. A Statement of Claim will be needed but if this is served on the defendant at the start of the litigation it will then be possible to enter judgment with the necessary declaratory relief after the passage of 14 days.

Vesting Orders

Combining the above approach with vesting orders under section 52 of the Trustee Ordinance allows a victim with the declaratory relief to then obtain their money. Vesting orders can be made when there is no prospect of the defendant transferring the victim's money back to them. This situation will clearly exist when the defendant has disappeared. The courts are nowadays prepared to make a vesting order against a bank where the funds are held, requiring the bank to transfer the sum back to the victim.

Justice

That the courts are prepared to give declaratory relief when a need arises is an encouraging development and combining this with the relief available in the Trustee Ordinance, victims can secure their property and have it transferred back to them more quickly and with less risk than before.

Miscellaneous

Anti-money laundering ("AML")

In their circular to licensed corporations and associated entities dated 26 January 2017, the SFC has identified compliance with AML and counter financing of terrorism ("**CFT**") as a focus for their market supervision.

The SFC has been and will continue to conduct in-depth reviews of firms' internal AML/CFT policies, procedures and controls.

During 2016 and the review of AML/CFT practices in over 290 firms, the SFC found more than 200 incidents of non-compliance. No doubt, the SFC's increased action is related to the fact that the Financial Action Task Force (the inter-governmental body promoting effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system) will be evaluating Hong Kong in mid-2018.

What can breaches of the AML/CFT requirements mean?

In April alone, the SFC has disciplined and fined:

- Guoyan Securities Brokerage (HK) Ltd. HK$4.5 million for breaches between 2010 and 2012 of the SFC's Prevention of Money Laundering and Terrorist Financing Guidance Note, the Guideline on Anti-Money Laundering and Counter-Terrorist Financing and Code of Conduct; and
- iStar International Futures Co. Ltd. HK$3 million for its failures to comply with AML requirements when processing third party deposits and transfers, such as not verifying the source of funds, providing AML training or having effective compliance.

Are you ready for new client agreements?

In December 2015, licensed intermediaries were instructed that they had until 9 June 2017 to comply with new Code of Conduct requirements governing the contents of all client agreements.

Aimed at reducing misselling and the effect of contractual boilerplate, client agreements are required to include a representation that the sale or recommendation of any financial product must be reasonably suitable to investors taking account of their financial situation, investment experience and investment objectives.

The SFC has stated that all client agreements must be in compliance with the above by 9 June. Failure to do so will no doubt incur disciplinary action.

Get in touch

Ivan Ng
Partner
T: +852 2533 2840
E: ivan.ng@shlegal.com

Ian Childs
Senior associate
T: +852 2533 2884
M: +852 6191 5088
E: ian.childs@shlegal.com

Stephenson Harwood is a law firm with over 900 people worldwide, including more than 150 partners. Our people are committed to achieving the goals of our clients - listed and private companies, institutions and individuals.

We assemble teams of bright thinkers to match our clients' needs and give the right advice from the right person at the right time. Dedicating the highest calibre of legal talent to overcome the most complex issues, we deliver pragmatic, expert advice that is set squarely in the real world.

Our headquarters are in London, with nine offices across Asia, Europe and the Middle East. In addition we have forged close ties with other high quality law firms. This diverse mix of expertise and culture results in a combination of deep local insight and the capability to provide a seamless international service.

STEPHENSON HARWOOD
罗夏信律师事务所