

PAUL BAILEY

**Enforcement Philosophy of
the Securities and
Futures Commission**

25

August 2001

Introduction

Public images about the Securities and Futures Commission (SFC) enforcement actions are often influenced by press stories, which can sometimes distort the public's perception of the SFC's role and its actions. The reality is more complex and often less dramatic.

The purpose of this paper is to provide an overview of the SFC's enforcement philosophy: why the SFC takes enforcement action, what enforcement powers it has, how it exercises those powers, and the principles that guide its enforcement action.

We hope this paper will help to dispel some of the misconceptions that there may be about how the SFC enforces relevant laws and standards.

Why the SFC Takes Enforcement Action

Hong Kong's securities and futures markets are the second largest in Asia outside Japan, and are widely considered the most international in Asia. One of the most crucial factors in Hong Kong's ability to attain and maintain this position is that its markets are generally seen as fair and efficient, so investors and market participants have confidence in them. One of the important factors behind this is that

the laws and standards governing our markets have been rigorously and credibly enforced.

Of course, most market participants, in the SFC's experience, want to (and do) comply with the law and relevant business and professional standards. But, unfortunately, there is a minority that, for whatever reason, fails to do so. To deal with the actions of this minority, there is an obvious need for an appropriate authority to act in the public interest, with the power to take necessary steps to try and ensure that:

- the actions of the minority do not cause potential loss to the investing public, or disrupt the securities and futures markets; and
- the persons responsible for wrongdoing are held accountable for their actions.

The SFC's Power to Take Enforcement Action

The SFC's responsibilities

Section 4 of the Securities and Futures Commission Ordinance (Cap. 24) sets out the SFC's functions as mandated by the Legislative Council.

Among the SFC's roles are enforcing the laws governing the securities and futures markets, and taking action to suppress illegal and certain improper or unethical conduct in those markets. For example, it is required to:

- ensure that there is proper compliance with the laws that it administers;
- report suspected insider dealing to the Financial Secretary for possible referral to the Insider Dealing Tribunal;
- take whatever other lawful action it considers appropriate to suppress illegal, improper or unethical conduct in the securities and futures markets and in trading in other financial products it regulates; and

- co-operate with local, national and overseas regulatory and law enforcement agencies (which would include enforcement issues).

The SFC's statutory powers

The SFC has extensive statutory powers so that it can perform its enforcement responsibilities. These include the power to:

- require a listed company or its group companies to produce documents where it appears to the SFC that, for example, the company's business has been carried on with intent to defraud its creditors, or for a fraudulent or unlawful purpose;
- require details of transactions in securities, futures contracts, property investment arrangements or leveraged foreign exchange trading;
- direct one or more people, usually SFC staff, to investigate any matter where the SFC has reason to believe, for example, an offence under any of the laws it administers may have been committed, or where insider dealing may have taken place. Once appointed an investigator can then require any person he reasonably believes or suspects of having in his or her possession or control any document which contains or is likely to contain information relevant to a lawful investigation to:
 - (a) produce the document;
 - (b) explain the document;
 - (c) answer SFC questions in an interview; and
 - (d) give the SFC all reasonable assistance in relation to its investigation;
- execute search warrants and seize documents relevant to a lawful investigation or a listed company inquiry subject to a successful application for a warrant before a Magistrate;

- report suspected insider dealing to the Financial Secretary for a possible referral to the Insider Dealing Tribunal;
- report suspected serious crime to the Department of Justice for possible criminal prosecution on indictment and/or to the Hong Kong Police or Independent Commission Against Corruption (ICAC) for further criminal investigation;
- prosecute in its own name any relevant summary offences under the legislation that it administers;
- institute disciplinary proceedings against registered or licensed persons for misconduct or not being fit and proper which may lead to a reprimand or a suspension or revocation of their registration or licence;
- apply to the Court of First Instance (CFI) for an order to remedy unfair prejudice to the interests of members of a listed company after consulting with the Financial Secretary;
- direct the stock exchange to suspend dealing in a listed security;
- issue various notices restricting a registered or licensed person's ability to deal with assets, restricting their business or requiring them to maintain certain assets in or outside Hong Kong;
- apply to the CFI for an order to wind up a company or licensed leveraged foreign exchange trader where it appears to the SFC to be expedient in the public interest to do so;
- apply for a bankruptcy order against a registered or licensed individual where it appears to the SFC to be expedient in the public interest to do so;
- apply to the CFI for an injunction restraining an actual or apprehended breach of a restriction notice, the Financial Resources Rules or, under the Leveraged Foreign Exchange Trading Ordinance (LFETO), a requirement in connection with a winding up or bankruptcy order for a licensee;
- apply to the CFI for various orders in relation to an actual or apprehended breach of the Securities Ordinance (SO) or LFETO (or subsidiary legislation made under the LFETO) or a condition of registration under the SO or a condition of a licence under the LFETO; and

- take disciplinary action before the Takeovers and Mergers Panel (in the form of the Takeovers and Mergers Executive) for a breach of the Hong Kong Code on Takeovers and Mergers or the Share Repurchases Code.

How the SFC Exercises its Enforcement Powers

The enforcement process

The process of enforcing relevant laws and regulations generally involves two main steps:

- identifying that a breach of the relevant laws or regulations has taken place, and those responsible for the breach; and
- taking necessary steps to protect the public interest and, if appropriate, to punish those responsible for the breach.

This process of enforcement is generally the responsibility of the SFC's Enforcement Division.

Identifying a breach of the relevant laws or regulations

The SFC does a number of things with a view to identifying whether or not there might be a breach of the relevant laws or regulations, and those who might be responsible. These include:

- carrying out market surveillance to see whether there is evidence of possible market misconduct (e.g. market manipulation or insider dealing);
- considering complaints from the public;
- considering referrals from the SFC's other divisions (Intermediaries and Investment Products, Corporate Finance and Supervision of Markets); and
- considering referrals from other organizations (e.g. the Hong Kong Police, the ICAC, or overseas regulators).

Investigations and inquiries: the SFC's role as an investigator

If the SFC reasonably suspects that there has been a breach of relevant laws or standards, it will conduct further investigations or inquiries to try and find out what has happened, and whether there is evidence of wrongdoing.

If it believes that a serious criminal offence may have been committed, it will refer the matter to the Department of Justice for prosecution on indictment and/or, for example, the Hong Kong Police or the ICAC for further investigation.

Taking steps to protect the public and punish wrongdoers

If, following its investigations or inquiries, the SFC finds sufficient evidence of wrongdoing, it may take whatever lawful steps it considers appropriate to protect the investing public. For example, it may apply to the Court for an injunction to restrain the wrongdoing.

If it is appropriate, it may also take action to punish the wrongdoers. In this context, the SFC may take disciplinary action against them, if they are registered or licensed intermediaries. Such disciplinary action may result in the suspension or revocation of their licences or registrations, or issuing reprimands.

The SFC also has the power to prosecute certain, less serious offences before the Magistrates' Court. These offences include, for example, unregistered dealing or advising on investments.

The SFC's enforcement principles

A number of important principles guide the SFC when considering and taking enforcement action. These start with the SFC's principal aims when taking or considering any enforcement action, and general principles that it looks to when seeking to achieve these aims.

What are the SFC's enforcement-related aims?

The SFC's key enforcement-related aims are to:

- **protect investors (and the public interest).** The SFC will take whatever lawful action it considers appropriate or necessary in the circumstances to protect investors and the interests of the public; and
- **maintain market integrity.** The SFC will take whatever lawful action it considers appropriate or necessary in the circumstances to maintain market integrity and confidence.

These aims are derived from the Objectives and Principles of Securities Regulation of the International Organization of Securities Commissions.¹ The SFC will keep these aims in mind when considering what enforcement action (if any) it should pursue in the circumstances.

Principles guiding the SFC's enforcement-related action

- **Stopping things before they happen.** The SFC believes it is better to stop improper conduct before it happens, or, if it has happened, stop it from continuing than to remedy it after the fact. In promoting the concept of prevention, we generally encourage intermediaries to foster a culture of compliance, and the investing public to learn about how they may do more to look after their own rights and interests.
- **Remedying what has happened.** If wrongdoing has already occurred, the SFC will take appropriate steps to try and remedy it. We will look at each situation in light of its particular

¹ The Objectives and Principles contain three objectives of securities regulation: protecting investors; ensuring markets are fair, efficient and transparent (market integrity); and reducing systemic risk. As some of these objectives are more relevant to the regulatory process of which enforcement action is only a part, we have only referred to protecting investors and maintaining market integrity. The Objectives and Principles are available at <http://www.iosco.org>

circumstances and consider what might be appropriate courses of action, keeping in mind the interests of the investing public.

It is important to note that, although the SFC is required to act in the public interest, it cannot itself seek compensation for those who have suffered loss as a result of wrongdoing, or directly assist them in their attempts to seek compensation through the Courts.

- **Punishing wrongdoers and deterring potential future wrongdoing.** Generally speaking, punishment is usually appropriate or necessary for those who have engaged, or tried to engage, in wrongdoing. Punishment serves a number of purposes. Perhaps the most important of these is that it generally deters wrongdoers from engaging in further wrongdoing. And it may also deter others from engaging in wrongdoing.

To try and maximise the deterrent effect, the SFC will generally publicise its actions, wherever appropriate, to make clear that those who engage in crime or improper conduct run the risk of being caught and punished.

Principles guiding the SFC's enforcement-related decisions

- **Firmness.** The SFC will make firm decisions, and it will stand firm if it believes it is appropriate to do so in the public interest.
- **Fairness.** The SFC will act fairly. It will seek to comply with all applicable professional standards, and statutory and common law standards of procedural fairness.
- **Consistency.** The SFC will try to ensure that any enforcement action it takes is generally consistent with past action taken. However, the SFC will consider each case in light of its specific facts and circumstances.
- **Proportionality.** The SFC will take enforcement action that is proportionate with the wrongdoing in question, the consequences of the wrongdoing, and the extent to which the person who engaged in the wrongdoing is blameworthy.

For example, in some instances, it may be inappropriate to take very severe action against someone that has inadvertently breached a requirement, but has caused very little or no loss to others. Conversely, it would generally be inappropriate to treat leniently deliberately criminal or otherwise blameworthy conduct that causes significant loss to investors.

- **Openness.** The SFC believes in open dialogue, wherever possible. To the extent that the law and the public interest allow, and if it believes it is appropriate to do so, the SFC may negotiate a settlement. This can sometimes resolve matters more quickly allowing more efficient use of the SFC's resources.

The SFC cannot represent or bind other bodies which may have an interest in the matter. In particular, the Department of Justice remains responsible for criminal prosecutions within Hong Kong and has the right to intervene in the SFC's conduct of summary prosecutions. The SFC will, where necessary or appropriate, consult such bodies when conducting settlement negotiations.

- **Effectiveness of action.** The SFC has limited resources on which there are many competing demands, and it has to make the best use of these resources. The SFC cannot do everything and must set priorities. By necessity, therefore, it will generally consider the costs and benefits of any action that it proposes to take, in light of its key aims and principles. Sometimes, this may mean that the SFC takes no action in relation to one matter (for example, where the SFC believes there has been a technical breach, which is unlikely to be repeated and has resulted in very little or no loss to investors) in favour of taking action in other, more important circumstances.

Co-operation with other regulators

- **Co-operating with other domestic regulators.** Sometimes it may be more appropriate for a regulatory body other than

the SFC to take action. Where this is the case, the SFC will do what it can to co-operate with other regulators.

The Hong Kong Monetary Authority, the Insurance Authority or the Mandatory Provident Fund Schemes Authority all have certain responsibilities for regulating certain activities in connection with Hong Kong's securities and futures markets. In addition, the Hong Kong Police, the ICAC and the Department of Justice are responsible for dealing with serious crime. As far as it is legally able and it is appropriate to do so in the circumstances, the SFC generally co-operates with these bodies to ensure proper conduct in the securities and futures markets, and to suppress financial crime and misconduct.

- **Co-operating with Mainland and overseas regulators.** Given that borders are quickly losing their meaning, the SFC also co-operates with regulators around the world, including its Mainland counterparts. Whenever it co-operates, it does so within the law, and often through agreements called "memoranda of understanding". Under these agreements, the SFC and non-local regulators agree to assist each other in relation to certain matters, provided certain requirements, both legal and non-legal, are met.

Conclusion

Each of the SFC's enforcement actions involves a careful balancing of a number of complex issues. These issues vary from case to case. In balancing them and making a decision, the SFC will always endeavour to act firmly, fairly, impartially, keeping in mind the main guiding principles and aims described here.