



Hong Kong

June 2020

SFC DISCIPLINARY ACTIONS IN MAY 2020

Hong Kong's securities regulator, the Securities and Futures Commission (**SFC**), continued its focus on disciplining licensed intermediaries for breaches of the Code of Conduct for Persons Licensed by or Registered with the SFC (**SFC Code of Conduct**) and corporate misconduct by companies listed on the Hong Kong Stock Exchange (**HKEx**) during May 2020. Disciplinary actions during the month included:

- the imposition of a HK\$7 million fine on a licensed intermediary for internal control failures involved in its sale of collective investment schemes;
- a court order requiring a listed company to reconstitute its audit committee and appoint independent auditors to review its internal controls in proceedings related to the company's falsification of its financial results; and
- the disqualification of former directors of a former listed company for misapplication of company funds.

1. Disciplinary action for Regulatory Breaches in the Sale of Collective Investment Schemes (CISs)

On 7 May 2020, the SFC announced¹ that it had reprimanded Mega International Commercial Bank Co., Ltd (**MICBC**) and fined it HK\$7 million for internal control failures relating to its sale of collective investment schemes (**CISs**) under section

196 of the SFO. MICBC is an authorized institution registered to conduct dealing in securities (Regulated Activity Type 1) under the Securities and Futures Ordinance (**SFO**).

The Hong Kong Monetary Authority (**HKMA**) conducted an onsite examination and subsequently investigated MICBC in relation to its CIS selling practices from August 2014 to July 2015 (**Relevant Period**). The HKMA identified certain irregularities in MICBC's selling practices and referred the case to the SFC.

The SFC investigated MICBC's conduct under section 182 of the SFO and revealed that in its sale of CISs during the Relevant Period, MICBC failed to implement adequate and effective controls as outlined below.

Client risk profiling

MICBC's salespersons were required to assess clients' risk tolerance level by a customer risk profiling questionnaire (**CRPQ**) during the Relevant Period. The SFC formed the view that the CRPQ's design was deficient based on the following findings:

- client information such as investment experience under the first section of the CRPQ did not carry any scores. There was no audit trail to show that the salespersons had considered this information;
- corporate clients were asked to select their own risk tolerance level in the CRPQ;

¹ <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=20PR42>

- MICBC failed to implement any controls to identify and assess conflicting answers in the CRPQ; and
- the risk tolerance level assigned to the clients was not consistent with the clients' investment objective in a few cases.

Failure to assess clients' knowledge of derivatives

MICBC's clients were required to complete a "Derivatives Experience Profiling Form" (**Derivatives Form**) during the know-your-client process (**KYC**).

The Derivatives Form asked the clients to confirm if they had:

- executed 5 or more transactions in any derivative products in the past 3 years;
- undergone training or attended courses on derivative products;
- work experience related to derivative products; and/or
- carried out activities related to derivatives in the capacity of a licensed or registered person.

If the clients' answer to any of the above questions was affirmative, they were considered to have sufficient knowledge in derivatives. The SFC found that MICBC's staff were not required to make enquires or gather relevant information about the clients' knowledge of derivatives during the KYC.

Suitability assessment process

MICBC implemented, among other things, the following measures to ensure the products recommended were suitable for its clients during the Relevant Period:

- Salespersons had to match a client's risk tolerance level with the product's risk rating for determination of any risk mismatch. In the case of a risk mismatch, salespersons were required to inform the client of the mismatch and warn the client of the relevant investment risk.
- From 1 October 2014, salespersons were also required to conduct the following assessments (**Additional Assessments**) and document the results in a product checklist (**Checklist**):
 - i) whether the client was a vulnerable customer;

- ii) any mismatch between the product tenor and the client's investment horizon;
- iii) whether the transaction would cause an investment objective mismatch; and
- iv) whether the client's total investment in the same type of product amounted to or exceeded 50% of the client's net worth or assets under MICBC's management, whichever is higher (**Over-concentrated transactions**).

- Salespersons were required to document their reason for product recommendations.

Nonetheless, the SFC noted the following deficiencies and irregularities:

- The Additional Assessments were not applied to fund switching transactions and subscriptions for regular savings funds (also known as monthly income plans, **MIP**) during the Relevant Period.
- Salespersons were not required to document the reason for their investment recommendations regarding fund switching transactions.
- MICBC only conducted the concentration assessment when the client responded in the CRPQ that his/her investment amount was 35% or more of his/her total assets.
- There were 233 over-concentrated transactions during the Relevant Period after 1 October 2014. No Checklist was completed for 156 over-concentrated transactions involving fund switching or MIP subscriptions. Although a Checklist had been completed for the remaining 77 over-concentrated transactions, 42 were not classified as an over-concentrated transaction in the relevant Checklists.
- If the funds could be redeemed freely at any time upon clients' requests, they were regarded by MICBC as suitable for any investment horizon. There was no record to show that MICBC's salespersons had considered the funds' investment objective and documented the reasons why such funds were regarded as suitable for the clients having regard to the clients' investment horizon.

- There was no guideline on the handling and approval of transactions with multiple mismatches/exceptions in different aspects, including the clients' risk tolerance level, investment objective, investment horizon and/or asset concentration level (**Multiple Mismatches transactions**).
- MICBC's executive officer was not required to document any reason for approving the mismatch transactions (including Multiple Mismatches transactions).
- A sample review of the Multiple Mismatches transactions showed that most of the explanations provided were too general and did not adequately justify the suitability of the intended transactions for the clients despite the risk mismatch and high asset concentration risk.

Product due diligence

The SFC also identified the following deficiencies in MICBC's performance of product due diligence (**PDD**):

- MICBC offered a total of 292 fund classes, around 60% of which had been sold by its Taiwan head office (**HO Funds**). MICBC merely checked whether the HO Funds were authorised by the SFC, and failed to independently assess the adequacy and quality of the PDD conducted by its head office, having regard to the Hong Kong regulatory requirements.
- MICBC only considered a limited number of factors during the risk rating exercise in relation to each of its funds, without taking into account relevant factors such as price volatility, market segment and certain product features, which might directly or indirectly affect the funds' risk return profiles.
- MICBC failed to establish any policies or procedures for assessing and identifying funds which might constitute derivative products.

SFC disciplinary action for breaches of SFC Code of Conduct

Having regard to all the circumstances, the SFC considered that the failures of MICBC constituted breaches of the following provisions of the SFC Code of Conduct:

- i) General Principle 2 requiring licensed and registered persons to act with due skill, care and diligence, in the best interests of their clients and the integrity of the market;
- ii) General Principle 3 and paragraph 4.3 (Internal control, financial and operational resources), which require licensed and registered persons to employ effectively the resources and procedures necessary to properly perform their business activities and have internal control procedures which can be reasonably expected to protect operations and clients from financial loss arising from professional misconduct or omissions;
- iii) General Principle 7 (Compliance) and paragraph 12.1 (Compliance: in general), which require licensed and registered persons to comply with, and implement and maintain measures appropriate to ensure compliance with, relevant regulatory requirements;
- iv) Paragraph 5.1(a) (Know your client: in general) requiring licensed and registered persons to take all reasonable steps to establish the true and full identity of each of their clients, and of each client's financial situation, investment experience, and investment objectives;
- v) Paragraph 3.4 (Advice to clients: due skill, care and diligence), which requires licensed and registered persons to act diligently and carefully in providing advice to a client and ensure that their advice and recommendations are based on thorough analysis and take into account available alternatives; and
- vi) Paragraph 5.2 (Know your client: reasonable advice) requiring licensed and registered persons to ensure the suitability of their recommendations or solicitations for clients is reasonable in all the circumstances having regard to information about clients of which they are or should be aware through the exercise of due diligence.

In determining the disciplinary action, the SFC considered that:

- MICBC took remedial actions to strengthen its suitability framework;

- MICBC engaged an independent reviewer to validate whether the HKMA's findings during the onsite examination were fully addressed, and whether its control mechanisms operated effectively in accordance with its internal policies and procedures, and undertook to submit the validation review report to the SFC and the HKMA as soon as it was available;
- there was no evidence that MICBC's failures resulted in losses borne by its clients;
- MICBC cooperated with the SFC in resolving its concerns; and
- MICBC had no previous disciplinary record with the SFC.

A copy of the Statement of Disciplinary Action² is available on the SFC website.

2. Court Order re. Falsification of Financial Position

On 5 May 2020, the SFC announced³ that it had obtained a court order in the Court of First Instance against Shandong Molong Petroleum Machinery Company Limited (**SMPMC**) requiring SMPMC to reconstitute its audit committee and to engage an independent external auditor to review its internal control and financial reporting procedures, after the company admitted that it had falsely and substantially inflated its financial position in six results announcements. SMPMC was listed on the GEM of the HKEx in April 2004, and transferred its listing to the Main Board in February 2007. Its principal business is the manufacture and sales of pipe products, pumping equipment and petroleum machinery.

The SFC conducted an investigation into SMPMC's window-dressing of material financial information, including the company's profits, in its unaudited quarterly and half-yearly results announcements for the first three quarters of 2015 and 2016. The SFC claimed that the results announcements falsely presented a relatively healthy financial position of SMPMC when the company was actually incurring losses.

The SFC commenced legal proceedings against SMPMC under section 214 of the SFO. This allows the SFC to bring proceedings in the High Court to seek redress for misconduct or other wrongdoing towards a listed company or its members

² <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/openAppendix?refNo=20PR42&appendix=0>

³ <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=20PR41>

by any person responsible for the conduct of the business or affairs of the listed company. Pursuant to section 214 of the SFO, the court may, among other things, make orders: (i) requiring the carrying out of any acts; and (ii) to disqualify a person from being a director or being involved, directly or indirectly, in the management of any corporation for a period of up to 15 years, if the person is found to be wholly or partly responsible for the company's affairs having been conducted in a manner, among other conduct, involving defalcation, fraud, misfeasance or other misconduct towards the company or its members.

The SFC alleged that the conduct of SMPMC's business and affairs involved defalcation, misfeasance or other misconduct that resulted in the company's shareholders not being provided with all the information they might reasonably have expected, and/or which was unfairly prejudicial to the shareholders.

The SFC also alleged that seven senior officers of SMPMC were, at the material time, the instigators or the mastermind of a scheme to inflate SMPMC's profits, or were knowingly involved or at least acquiesced and/or turned a blind eye to the same by, overstating revenue and understating costs for the financial years 2015 and 2016.

As a result, the SFC is also seeking disqualification orders against SMPMC's seven current and former senior officers allegedly responsible for the scheme of profit inflation.

3. Disqualification Orders against 3 former directors of EganaGoldpfeil (Holdings) Ltd (EHL)

On 11 May 2020, the SFC announced⁴ that it had obtained disqualification orders in the Court of First Instance against three former executive directors of EHL, namely Mr. David Wong Wai Kwong, Mr. Peter Lee Ka Yue, and Mr. Chik Ho Yin, for their involvement in the company's misapplication of funds. EHL was listed on the Main Board of the HKEx on 25 June 1993 and was formally delisted by the HKEx on 4 January 2012.

On 1 August 2011, the SFC announced that it had started legal proceedings in the Court of First Instance seeking an order to disqualify Wong, Lee and Chik and an order that they compensate EHL for its losses.

The SFC alleged the following:

⁴ <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=20PR43>

- KPMG's independent review of certain EHL receivables showed that the recoverability of receivables amounting to approximately HK\$2.55 billion as at September 2007 appeared doubtful (**doubtful receivables**). The doubtful receivables were owed by eight debtor companies (**doubtful debtors**). EHL eventually made full impairment provisions for the doubtful receivables as losses amounting to HK\$2.6 billion.
- The SFC investigated and found that the directors and/or controllers of at least seven of the doubtful debtors were nominee directors and/or bank signatories appointed by Wong and acted under Wong's instructions.
- The doubtful debtors received payments from EHL group purportedly under the promissory notes and investment agreements. They then immediately transferred the payments to other doubtful debtors and other companies, or people under the control of or related to Wong. Substantial amounts of the money were eventually routed back to the EHL group on the same day and appeared to be round-robin transactions. Other amounts were transferred to companies connected to Wong.
- The fund flows connected to the doubtful receivables appeared to be inconsistent with their purposes recorded in EHL's books and records, and the relevant underlying transactions seemed bogus.
- Wong, Lee and Chik approved the transactions and signed cheques giving rise to the doubtful receivables.

The SFC alleged that Wong, Lee and Chik failed to inquire properly and perform appropriate due diligence before causing or permitting EHL to enter into the transactions and parting with substantial sums of money. The SFC further alleged that they caused or permitted the misapplication or misuse of EHL's funds, and exposed the group to unnecessary and unreasonable risk of losses.

Disqualification of Directors

The court found that Wong, Lee and Chik had approved the transactions and signed the cheques giving rise to the doubtful receivables, including payments to at least seven debtors which were in fact controlled by Wong, and the underlying transactions for the payments were not genuine commercial transactions. The three former directors failed to make proper inquiries and conduct appropriate due diligence before causing or allowing EHL to enter into the transactions.

As a result, Wong, Lee and Chik were disqualified from being directors or participating in the management of any corporation in Hong Kong without leave of the court, for a period of nine years, six years and six years respectively, effective from 7 May 2020.

Refusal of Compensation Order under section 214 SFO

In respect of the SFC's petition for compensation orders against Wong, Lee and Chik for a payment of HK\$622 million to EHL, the court refused to grant the compensation orders. Pursuant to section 214(2)(e) of the SFO, the court has the power to make any other order it considers appropriate, whether for regulating the conduct of the business or affairs of the corporation in future, or for the purchase of the shares of any members of the corporation by other members or by the corporation, or otherwise. In analysing section 214, the court stated that irrespective of whether a respondent has benefitted financially, a compensation order can be made in appropriate circumstances. However, in this case, the court concluded that it should be for EHL's liquidators to assess the efficacy as to whether it would be beneficial to bring proceedings in the name of EHL against any party.

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