SFC Proposes Significant Amendments to SFO Enforcement Regime

On 10 June 2022, the Securities and Futures Commission (**SFC**) launched a two-month consultation on proposed amendments to the enforcement-related provisions of the Securities and Futures Ordinance (**SFO**).

The Consultation Paper's proposals are far-reaching, comprising the following three principal proposals:

- to amend section 213 of the SFO to enable the SFC to apply to the Court of First Instance (**CFI**) for injunctions and other orders (including investor compensation orders) where it has exercised any of its powers under section 194 or 196 of the SFO against an SFC-regulated person. The amendment is significant. If implemented, it could allow the CFI to require SFC-licensed or registered persons, such as IPO sponsors, to compensate investors where they have breached provisions of the SFC's codes and guidelines;

- to amend the professional investors exemption in section 103(3)(k) of the SFO so that it applies only to advertisements of investment products where the advertisement is issued only to professional investors identified as such in advance through intermediaries' know-your-client and related procedures. The same amendment will be made to the section 103(3)(j) exemption for investment products sold or intended to be sold only to persons outside Hong Kong; and

- to broaden the insider dealing provisions of the SFO to cover: (i) insider dealing perpetrated in Hong Kong with respect to securities listed on overseas stock markets or their derivatives; and (ii) insider dealing perpetrated outside of Hong Kong if it involves Hong Kong-listed securities or their derivatives.

Comments on the proposed amendments should be submitted to the SFC no later than 12 August 2022.

Part 1 - Amendments to Section 213 of the SFO to Expand the Basis on which the SFC may Apply for Remedial and Other Orders against a Regulated Person

The SFC proposes to expand section 213 of the SFO to allow it to apply to the CFI for injunctions and other orders, including orders to pay compensation, where it has exercised its disciplinary powers under section 194 or 196 of the SFO against a regulated person.[1]

Section 213 of the SFO

Currently, section 213(1) of the SFO allows the SFC to apply to the CFI for various orders to provide remedies for persons affected by another person's breach of:

- any of the relevant provisions;[2]
- any notice or requirement given or made under or pursuant to any of the relevant provisions;
- any of the terms and conditions of an SFO licence or registration; and
- any other condition imposed under or pursuant to any provisions of the SFO.

"Relevant provisions" are defined to include any provision of: the SFO, Parts II and XII of the Companies (Winding Up and Miscellaneous Provisions) Ordinance which set out the prospectus regime; Part 5 of the Companies Ordinance which relates to a company's buy-back of its own shares or giving financial assistance for the acquisition of its own shares; and Part 2 (except section 6) of the Anti-Money Laundering and Counter-Terrorist Financing Ordinance.

The orders that can be made under section 213(2) include:

- an order restraining or prohibiting a breach of the relevant provisions;
- an order requiring a person to take such steps as the CFI may direct, including steps to restore the parties to any transaction to the position in which they were before the transaction was entered into (a **Restoration Order**);
- an order restraining or prohibiting a person from dealing in any specified property;
- an order appointing an administrator;
- an order declaring that a contract is void or voidable; and
- an order directing a person to do or refrain from doing any act to ensure compliance with any other court order made.

Section 213(8) of the SFO further provides that the CFI can make an order requiring the person to pay damages to another person, either in addition to or in substitution for an order made under section 213(1).

The SFC has been successful in obtaining Restoration Orders under section 213 to compensate investors for financial loss suffered in a number of cases. Given the lack of a class action regime, it has become an important tool for the SFC to seek compensation for investors. In the landmark case of Tiger Asia Management LLC, for example, the CFI made a Restoration Order against the company and two of its officers to pay HK$45 million to investors affected by their insider dealing, which they admitted.[3] The SFC has also sought Restoration Orders against IPO issuers to compensate investors for losses suffered due to false or misleading disclosure in IPO prospectuses. In 2012, the CFI made a Restoration Order against Hontex International Holdings Company Limited requiring it to buy back its IPO shares from investors at a cost of HK$1.03 billion following its admission that it had contravened section 298 of the SFO (the prohibition on the distribution of false or misleading information likely to induce the entering into of a securities transaction). The Hontex case was however unusual since the SFC was able to freeze HK$832 million of the HK1 billion raised in the IPO which remained in the company's Hong Kong bank accounts. The controlling shareholders then agreed to top up that amount to fund the share buy-back.[4] It is more often the case, however, that the issuer's recoverable assets are insufficient to compensate IPO investors' losses.

Limitations of Section 213 of the SFO

The SFC cannot apply for orders under section 213 of the SFO when a regulated person has been found guilty of misconduct or not to be a fit and proper person to remain regulated under section 194 or 196 of the SFO, unless the conduct which gave rise to the finding also breached one of the relevant provisions, requirements or conditions described in section 213(1) above. This means that a breach of the SFC's codes and guidelines (such as the SFC Code of Conduct for Persons Licensed by or Registered with the SFC (the **SFC Code of Conduct**) by a regulated person, however serious, cannot currently give rise to a cause of action under section 213 if it does not fall within any of the circumstances set out in section 213(1).

Although sections 194 and 196 of the SFO enable the SFC to impose a range of disciplinary sanctions against a regulated person who is guilty of misconduct or not fit and proper to remain a regulated person, they do not give the SFC the statutory power to require the regulated person to take any steps to restore, compensate or otherwise protect the interests of investors or clients who are adversely affected by the regulated person's conduct.

Proposed Amendments to Section 213 of the SFO

The SFC is therefore proposing to amend section 213 to:

- introduce an additional ground under new section 213(1)(c) to allow the SFC to apply for orders under section 213 where it has exercised any of its powers under section 194(1), 194(2), 196(1) or 196(2) against a regulated person; and
- introduce an additional order under section 213(2) that would allow the CFI to order a person to restore the parties to a transaction to the position they were in before the transaction was entered into (i.e. a Restoration Order), where the SFC has exercised any of its powers under section 194 or 196 against a regulation person.

If these proposals are implemented, the CFI would also be able to order a regulated person to pay damages under section 213(8) where the SFC has exercised its disciplinary powers under section 194 or 196.

Other consequential amendments proposed would:

- add an additional ground to section 213(3A) to enable the SFC to apply for orders under section 213 where it has exercised any of its powers under section 194(1), 194(2), 196(1) or 196(2) against a regulated person who is a director, investment manager, custodian or a sub-custodian of an open-ended fund company; and
- amend section 213(7) so that an order can be made under subsection (1) whether or not the person intends to engage or continue to engage in any new matters which gave rise to the SFC's exercise of a disciplinary power referred to in the new section 213(1)(c) (i.e. on the SFC's exercise of its powers under section 194 or 196). This is based on the existing section 213(7)(a) which makes the same provision in respect of orders under section 213(1)(a)(i) to (v).

Implications of the Proposed Amendments

The amendments could have significant consequences since they would allow the SFC to apply to the CFI for an order that a regulated person should compensate investors who suffer financial loss where it has brought section 194 or 196 proceedings against a regulated person which is: (i) guilty of misconduct; or (ii) in the opinion of the SFC, not a fit and proper person to remain regulated. 'Misconduct' is defined broadly to include breach of any relevant provision and an act or omission in the carrying on of any regulated activity which, in the opinion of the SFC, is likely to be prejudicial to the interest of the investing public. Further, breach of the provisions and general principles of the SFC Code of Conduct can form the basis of the SFC's determination that a regulated person is no longer fit and proper. In particular, paragraph 17.1(c) of the SFC Code of Conduct provides that the SFC will have regard to IPO sponsors' compliance with the sponsor obligations under paragraph 17 (which include the due diligence requirements) in assessing whether they are fit and proper.

It is worth noting that the SFC has brought disciplinary proceedings under sections 194 and 196 against the sponsors of a number of IPOs involving false or misleading prospectus disclosure based on the sponsors' breach of the sponsor obligations and requirements for the conduct of due diligence set out in paragraph 17 of the SFC Code of Conduct and in the Listing Rules. These actions resulted in the imposition of reprimands and record fines, including a fine of HK$224 million imposed on Morgan Stanley Asia Limited and a fine of HK$375 million imposed on UBS AG and UBS Securities Hong Kong Limited. Currently, the SFC cannot seek compensation for investors where it considers a sponsor to be in breach of its obligations, unless the sponsor can also be shown to have breached one of the relevant provisions. That would change under the proposed section 213 amendments.
Mis-selling of investment products and breach of the SFC Code of Conduct's suitability requirements could similarly lead to the SFC seeking compensation for aggrieved investors.

Part 2 – Amendments to Exemptions in Section 103 of the SFO

Section 103(1) of the SFO makes it an offence to issue, in Hong Kong or elsewhere, an advertisement, invitation or document (an **Advertisement**) which, to the person's knowledge, contains an invitation to the public to deal in various investment products (including (among others) securities, structured products and interests in collective investment schemes (i.e. funds)), unless the issue of the Advertisement has been authorised by the SFC under section 105 of the SFO. Section 103(1) is subject to a number of exemptions as provided for in subsections (2), (3) and (5) to (9).

In 2015, the Court of Final Appeal (**CFA**) in the *Pacific Sun Advisors*[5] case gave a wider construction to the professional investors exemption under section 103(3)(k) than the SFC believes was intended by the underlying policy. Section 103(3)(k) provides an exemption from the section 103(1) offence for Advertisements made in respect of securities, structured products or interests in a collective investment scheme, that are or are intended to be disposed of only to professional investors.

The SFC instituted proceedings against Pacific Sun Advisors and its chief executive officer for breach of section 103(1) of the SFO with respect to Advertisements for the launch of a fund which had been issued to the public. The Advertisements were not authorised by the SFC. It was the SFC's case that for the exemption in section 103(3)

(k) to apply, Advertisements must make it clear that the relevant advertised investment product is or is intended only for professional investors.

The defendants argued that the exemption applied since the Advertisements related to an investment product (i.e. the fund) that was intended to be sold, and was in fact sold, only to professional investors, notwithstanding that the restriction to professional investors was not stated in the Advertisements.

The CFA accepted the defendants' arguments and found that the exemption applied.

SFC's Views on the CFA Interpretation of the Section 103(3)(k) Exemption

The SFC notes in the Consultation Paper that the result of the CFA judgment is that the section 103(3)(k) professionals exemption will apply to any advertisement relating to products that are or are intended to be sold only to professional investors. Consequently, the position now is that unauthorised advertisements of investment products which may not be suitable for retail investors may be issued to the general public even though the investment products are intended for sale only to professional investors. As a result, retail investors may be exposed to unauthorised offers or solicitations to invest in risky or complex products which are unsuitable for them.

In addition, although liability under section 103(1) would crystallise at the time when an advertisement is issued, in practical terms, enforcement action needs to wait until the sale of a product has taken place in order to determine to whom it has been sold and whether the section 103(3)(k) exemption applies. The SFC is also concerned that a mere intention to sell investment products only to professional investors would suffice for an exemption from the authorisation regime under section 103(1). It considers that this makes the regime extremely difficult to enforce and to be contrary to the purposes of Part IV and section 103(1) which it regards as regulating the *advertising* of investment products, not their *sale*.

Proposed Amendment of Sections 103(3)(j) and (k) of the SFO

The SFC is therefore proposing to amend section 103(3)(k) to apply the professional investors exemption to the point in time when advertising materials are issued. This would be done by exempting from the authorisation requirement only those Advertisements which are issued only to professional investors.

If the proposal is implemented, unauthorised Advertisements of investment products which are or are intended to be sold only to professional investors must only be issued to professional investors who have been identified as such in advance by an intermediary through its know-your-client and related procedures, regardless of whether or not such an intention has been stated on the Advertisements. It will no longer be possible to issue Advertisements for investment products to the public (or a section of the public), e.g. by making them available on a website, even if the products themselves will only be sold to professional investors, unless the issue of the Advertisement has been authorised by the SFC.

The SFC is also proposing to make the same amendments to section 103(3)(j), which provides an exemption in relation to investment products sold or intended to be sold only to persons outside Hong Kong, and is phrased similarly to the professional investors exemption.

Part 3 – Amendments to the Insider Dealing Provisions of the SFO

Division 4 of Part XIII and Division 2 of Part XIV of the SFO establish mirroring civil and criminal insider dealing regimes. Both regimes apply to insider dealing with respect to: (a) Hong Kong-listed securities or their derivatives; and (b) securities dually-listed in Hong Kong and another jurisdiction or their derivatives. The current regimes do not apply to market misconduct or the offence of insider dealing in Hong Kong with respect to securities listed on overseas stock markets[6] or their derivatives, nor do they expressly apply to acts constituting insider dealing perpetrated outside Hong Kong in respect of Hong Kong-listed securities or their derivatives.

The SFC is proposing to expand the scope of the SFO's insider dealing provisions to cover:

(a) insider dealing perpetrated in Hong Kong with respect to overseas-listed securities or their derivatives; and

(b) insider dealing perpetrated outside of Hong Kong, if it involves any Hong Kong-listed securities or their derivatives.

Reduced Ability to Tackle Insider Dealing

The SFC notes in the Consultation Paper that it has only been able to deal with suspected insider dealing in Hong Kong of overseas-listed securities or their derivatives by providing intelligence to securities regulators in

the relevant jurisdictions. However, this rarely deals effectively with cases of serious of insider dealing since the majority of evidence is available in Hong Kong. The SFC believes that in order to send a strong deterrent message, it needs to be able to punish misconduct directly in Hong Kong.

The Consultation Paper also gives the example of *Securities and Futures Commission v Young Bik Fung & Ors* [2019] HKC 254 which involved defendants in Hong Kong dealing in the shares of an offshore-listed company on the basis of inside information acquired in Hong Kong. The insider dealing regime did not apply because the company was not listed in Hong Kong, although the SFC was successful in obtaining civil remedies under section 213 of the SFO by establishing that the defendants had breached section 300 of the SFO, which prohibits fraudulent or deceptive schemes in transactions involving securities. However, the SFC points out in the Consultation Paper that there is a significant conceptual difference between the type of conduct that section 300 prohibits as compared to that prohibited by the insider dealing provisions. Section 300 aims to deal with acts of fraud or deception involving transactions between specific people, rather than conduct that deceives and misleads the market as a whole. As a result of this conceptual difference, the nature and amount of relief available is different. In the Young Bik Fung case, for example, one of the defendants, a fiduciary, had defrauded or deceived her principals (her employer, a Hong Kong law firm, and its client, a Hong Kong bank), by misusing inside information so that the defendants (including herself) could profit from securities trading. The section 213 Restoration Order granted by the Court only required her to return the profits from the illicit trades to the bank which was a victim of the fraud or deception. However, if the Restoration Order was based on a contravention of the insider dealing provisions (that is, section 270 or 291), the order would be calculated on the basis of restoring aggrieved investors impacted by the illicit trades to the position they were in before entering into the relevant transactions.

The SFC's ability to impede insider dealing is further constrained by the fact that the SFO does not expressly cover insider dealing with respect to Hong Kong-listed securities or their derivatives where the acts giving rise to a contravention of section 270 or 291 take place outside Hong Kong. The absence of express territorial provisions means that the SFC has to apply the common law test to determine the territorial jurisdiction in each case.[7] The SFC estimates that around 61% of the insider dealing cases it handled between 2017 and 2021 concerned insider dealing perpetrated outside Hong Kong in respect of Hong Kong-listed securities or their derivatives. It therefore proposes to expand the SFO insider dealing regimes to include any act which takes place outside of Hong Kong in respect of Hong Kong-listed securities or their derivatives.

Comparisons with other Common Law Jurisdictions and other Market Misconduct Provisions of the SFO

The insider dealing laws of other major common law jurisdictions govern both overseas conduct relating to securities of local issuers and local conduct relating to securities of overseas issuers. This is the case in Australia and Singapore, as well as the UK.

Other market misconduct provisions of the SFO, including false trading (sections 274 and 295), price rigging (sections 275 and 296) and stock market manipulation (sections 278 and 299) adopt a comparable approach in terms of the territorial scope. These other market misconduct provisions expressly cover acts committed in Hong Kong or elsewhere which affect Hong Kong's financial markets, as well as unlawful acts committed in Hong Kong which affect non-Hong Kong financial markets.

The SFC's proposed expansion of the scope of the insider dealing provisions would therefore align them with those of other common law jurisdictions and the other market misconduct provisions of the SFO. The proposed amendments would also strengthen the SFC's regulatory powers to tackle insider dealing conducted in Hong Kong involving A-shares listed in mainland China which are traded through Stock Connect.

SFC Proposals regarding Insider Dealing Provisions

The SFC proposes to:

- amend the definition of "listed" in sections 245(2) (civil regime) and 285(2) (criminal regime) of the SFO to include overseas-listed securities or their derivatives; and
- add a new section to Parts XIII and XIV of the SFO to expand the territorial scope of the insider dealing regimes to include: (i) any acts of insider dealing involving Hong Kong-listed securities or their derivatives regardless of where they occur; and (ii) any acts of insider dealing involving overseas-listed securities or their derivatives if any one or more of such acts occur in Hong Kong.

If the proposals are implemented, the provisions which currently extend the scope of the insider dealing provisions to dealings in dually-listed Hong Kong securities on stock markets outside Hong Kong or their derivatives (section 270(2) (civil regime) and section 291(7) (criminal regime) of the SFO), would become redundant. The SFC therefore proposes to repeal those provisions.

In addition, the SFC proposes to add a new subsection to sections 282 and 306 of the SFO so that, in relation to the proposal to extend the insider dealing regimes to cover overseas-listed securities (or their derivatives) where any act occurs in Hong Kong, a person will only be liable for insider dealing if his or her conduct is also unlawful in the relevant overseas jurisdiction. This is consistent with the position for other types of market misconduct.

It is also proposed to amend section 271(5) of the SFO, that is the off-market dealings defence, so that the defence is also available in respect of insider dealing involving overseas-listed securities (or their derivatives).

There is currently a discrepancy between the formulation of the mens rea element in relation to the disclosure of inside information under sections 270(2)(b) and 291(7)(b) (with respect to dually-listed securities or their derivatives) and that under other sub-sections in sections 270 and 291 dealing with disclosure of inside information in relation to securities listed only in Hong Kong or their derivatives. Under sections 270(2)(b) and 291(7)(b), the mens rea element can be met where the person with inside information knows or has reasonable cause to believe that the person to whom the inside information is disclosed, *or some other person*, may deal in the listed securities or their derivatives. The mens rea for the sub-sections relating to securities listed only in Hong Kong or their derivatives is narrower, requiring the person disclosing inside information to know or have reasonable cause to believe *only* that the person to whom the inside information is disclosed would deal in the listed securities. The SFC is proposing to align the two formulations by adopting the wording in sections 270(2)(b) and 291(7)(b).

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[1] Regulated persons include: (i) licensed corporations, their responsible officers, licensed representatives and persons involved in their management; and (ii) registered institutions, their executive officers, registered individuals and persons involved in the management of the regulated activity(ies) for which they are registered

[2] Section 1 of Part 1 of Schedule 1 to the SFO

[3] SFC press release "Tiger Asia admits insider dealing and ordered to pay investors $45 million" at https://apps.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/enforcement-news/doc?refNo=13PR127

[4] SFC speech "Compliance and corruption across Asia compliance summit Asia" at https://www.sfc.hk/-/media/EN/files/ER/PDF/Mark_20121108.pdf

[5] Pacific Sun Advisors Ltd & Anor v Securities and Futures Commission [2015] HKCFA 27

[6] "Overseas stock market" refers to stock markets outside of Hong Kong, similar to the usage of "relevant overseas market" in sections 245 and 285 of the SFO

[7] This test is whether a substantial measure of the activities of the crime have taken place within Hong Kong: *HKSAR v Wong Tak Keung* (2015) 18 HKCFAR 62 and *Securities and Futures Commission v Young Bik Fung And Others* [2018] 1 HKC 246

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