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Hong Kong SFC Consults on Significant Reforms to the SFO Enforcement Provisions

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On June 10, 2022, the Securities and Futures Commission ("**SFC**") published a consultation paper on proposed amendments to enforcement-related provisions of the Securities and Futures Ordinance[1] [2] ("**SFO**") (the "**Consultation Paper**"). This is particularly noteworthy, as the Consultation Paper marks the first time that the SFC has consulted on changes to enforcement-related provisions since the introduction of the SFO 20 years ago. If all measures sought by the SFC are ultimately implemented, we consider it highly likely that we will see a more aggressive approach to enforcement by the SFC. In particular, the changes sought by the SFC to section 213 of the SFO would make it far easier for the SFC to obtain orders compelling licensed corporations / registered institutions that are found guilty of engaging in misconduct under the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("**Code of Conduct**") to provide investor compensation in relation to that misconduct. At present, there are significant limitations on the SFC's power to obtain such investor compensation, which have largely shielded licenced corporations and registered institutions from the sort of significant investor compensation claims that have been awarded in other jurisdictions. As such, if this change is implemented, it may well be a "game changer" for the Hong Kong enforcement landscape.

The Consultation Paper also suggests that the SFC has developed a greater appetite for seeking legislative change rather than relying (as it has done in recent years) on providing guidance to the market through the issue of codes, guidelines and circulars. That said, given that many of the changes sought by the SFC could not be achieved through the issue of guidance (as they are largely intended to address the consequences of certain Court of Final Appeal cases and limitations in the drafting of the SFO itself), care must be taken not to assume that this suggests an entirely new approach by the SFC.

I. Expansion of section 213 of the SFO

The most significant and potentially wide reaching amendment sought by the SFC concerns section 213 of the SFO, which provides the SFC with power to seek and obtain injunctive relief from the Court of First Instance ("**CFI**"). At present, section 213 provides the SFC with the power to seek the following forms of relief:

- an order restraining or prohibiting a breach of the relevant provisions;
- an order requiring a person to take steps to restore the parties to any transaction to the position in which they were before the transaction was entered into;
- an order restraining or prohibiting a person from dealing in a 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

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William R. Hallatt

Emily Rumble

Arnold Pun

Becky Chung

compliance with any other court order made.

However, under the current drafting of section 213, the SFC may only seek this relief in order to provide remedies for persons affected by contraventions of another person of certain "relevant provisions" and any notice, requirement, conditions, and terms of any license or registration. "Relevant provisions" is defined comparatively broadly in Schedule 1 of the SFO as including the SFO, its subsidiary legislation and certain provisions of the AMLO, Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32) and Companies Ordinance (Cap. 622). However, this definition does not include the SFC's codes and guidelines, including most notably the Code of Conduct.

What this means in practice is that at present, as noted by the SFC in its Consultation Paper, the SFC cannot apply for the above orders under s 213 of the SFO when a regulated person has been found by the SFC through its disciplinary processes to be guilty of misconduct or to not be a fit and proper person to remain a regulated person under section 194 or 196 of the SFO, unless the conduct which gave rise to the SFC's finding also constituted a contravention of the "relevant provisions" and any notice, requirement, conditions, and terms of any license or registration. However, in practice, the extent to which the SFC has relied upon the issue of codes, guidelines and circulars to communicate its regulatory expectations to the market in recent years means that it is comparatively rare for the conduct at the centre of the SFC's disciplinary processes to give rise to a contravention of "relevant provisions", as opposed to a breach of said codes, guidelines and circulars.

The SFC has therefore proposed in the Consultation Paper that section 213 be amended to, amongst other matters:

- introduce an additional ground in s 213(1) which would allow the SFC to apply for orders under section 213 where it has exercised any of its powers under sections 194(1), 194(2), 196(1) or 196(2) against a regulated person;
- introduce an additional order in section 213(2) that would allow an order to be made by the CFI to restore the parties to any transaction to the position in which they were before the transaction was entered into, where the SFC has exercised any of its powers under sections 194 or 196 in respect of the regulated person; and
- enable the CFI to make an order under section 213(8) against a regulated person to pay damages where the SFC has exercised any of its disciplinary powers against a regulated person.

The SFC has argued in the Consultation Paper that these changes are necessary to '*give the SFC more effective means to protect investors and the interests of clients of regulated persons*'. We consider that if these changes are implemented, these amendments will likely have a significant impact on the enforcement landscape in Hong Kong for several reasons:

- First, as noted above, the SFC's current disciplinary powers in respect of breaches of its codes, guidelines and circulars are comparatively limited, particularly in relation to the implementation of financial penalties. At present, fines are capped at a maximum of HK$10 million or three times of the profit gained or loss avoided, whichever is the higher. While this methodology has still resulted in the imposition of a range of significant fines in recent years, these fines could pale in significance to the size of potential investor compensation claims that could be made in relation to future cases. We anticipate future investor compensation claims under an amended section 213 will be particularly significant in the context of IPO sponsor misconduct cases, where IPO sponsors have historically often be the last parties left standing after the collapse of a fraudulent listco – or will simply be the party left standing with the deepest pockets. Similarly, misselling / suitability cases would also expose regulated firms to both SFC disciplinary action as well as significant investor compensation orders, compelling the regulated firm to restore

the investors in question to the position they would have been in if not for the regulated firm's misconduct.

- Second, the SFC has suggested in the Consultation Paper that the CFI should be able to make an order under section 213(8) against a regulated person to pay damages where the SFC has exercised any of its disciplinary powers against a regulated person. As noted above, the SFC's fining power is currently capped at a maximum of $10 million or three times of the profit gained or loss avoided, whichever is the higher. Any order to pay damages under the amended section 213(8) would presumably not be subject to the current cap on the SFC's fining powers, meaning that we may also see a significant increase in the penalties imposed on regulated persons by way of damages orders (in addition to investor compensation claims).
- Third, the non-financial disciplinary measures currently available to the SFC are primarily focused on impacting a licensed firm and/or individual's ability to continue to be licensed (e.g. licence revocation and suspension). However, these measures are limited in effectiveness where dealing with individuals or firms that have no desire to continue to be licensed or who are no longer employed in the industry. Allowing the SFC to more easily seek one or more of the wide range of orders available under section 213 in relation to these individuals and firms is likely to increase the effectiveness of sanctions against such persons.

II. Amendment to PI exemption to the s 103 prohibition on the issue of advertisements

The second change proposed by the SFC concerns section 103 of the SFO. Section 103(1) makes it a criminal offence to issue or be in possession for the purposes of issue an advertisement, invitation or document which, to the person's knowledge, contains an invitation to the public to enter into an agreement to deal in securities or any other structured products, to enter into regulated investment agreements, or to participate in a collective investment scheme, unless authorized by the SFC to do so. Section 103(3) further contains a list of exemptions to the marketing restrictions under s 103, including s 103(3)(k), which provides an exemption from the authorization requirement for advertisements of offers of investments that are disposed of, or intended to be disposed of, only to professional investors (the "**PI Exemption**").

In its Consultation Paper, the SFC aims to right what it considers to be a "wrong" in the CFA's interpretation of the PI Exemption in the 2015 case of *Pacific Sun Advisors Ltd & Anor v Securities and Futures Commission*.[3] In that case:

- The SFC had commenced proceedings against a licensed corporation and its chief executive officer for contravention of section 103(1) in relation to emails sent to all potential investors and publications on the licensed corporation's website marketing the launch of a fund. The advertisements contained disclaimers stating that the materials '*should not be construed as an offer to sell nor a solicitation of any offer to buy shares in any fund*'. The SFC argued that for the PI Exemption to apply to advertising materials, the advertising material itself must make clear that the advertised investment product is or is intended only for PIs, which these emails did not do.
- However, Pacific Sun argued that while the advertisements were issued to the general public, it was sufficient that the fund itself was intended to be sold and had in fact only been sold to PIs, even though this intention was not clearly stated in the advertisements.

The CFA agreed with Pacific Sun in its decision, and found that the PI Exemption did apply in this case.

In the Consultation Paper, the SFC proposes the amendment of s 103(3)(k) to focus on

the point in time when the advertising materials are issued, by exempting from the authorisation requirement those advertisements which are issued only to PIs. This would mean that following this amendment, unauthorised advertisements of investment products which are or are intended to be sold only to PIs may only be issued to PIs 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.

The SFC argues that this amendment is necessary on the basis that the *Pacific Sun* decision has created a situation in which:

- unauthorized advertisements of products unsuitable for retail investors may be issued to the general public even if only intended for sale to PIs, exposing retail investors to offers to invest in risky and unsuitable products; and
- enforcement action may not take place 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 to the advertisement prior to that sale, notwithstanding the fact that section 103(1) clearly only regulates the issue of advertisements rather than the sale of such products. The SFC has noted that this, combined with the fact that a mere intention to sell investment products only to PIs would suffice for an exemption from the authorization regime under section 103(1), '*makes the regime extremely difficult, if not impossible to enforce*', and contradicts the intention and purpose of section 103.

III. Amendment to territorial scope of insider dealing provisions

The final change proposed by the SFC concerns the civil and criminal regimes under sections 270 and 291 of the SFO in respect of insider dealing, both of which currently apply to insider dealing concerning Hong Kong-listed securities or their derivatives, and securities that are dual-listed in Hong Kong and another jurisdiction or their derivatives. However, as noted by the SFC, the current regime leaves a regulatory lacuna with regard to market misconduct or insider dealing:

- committed in Hong Kong with respect to overseas listed securities or their derivatives; and
- committed outside of Hong Kong in respect of Hong Kong listed securities or their derivatives.

The SFC proposes to close this gap in the legislation by extending the scope of the insider dealing provisions in Hong Kong to address insider dealing in Hong Kong with regard to overseas-listed securities or their derivatives, and to address conduct outside of Hong Kong in respect of Hong Kong listed securities or their derivatives. To support this proposal, the SFC has argued in the Consultation Paper that these amendments are necessary in order to ensure that they have the power to tackle cross-border insider dealing and market misconduct in order to preserve the integrity and reputation of Hong Kong's financial industry and market. To support this position, the SFC has cited the case of *Securities and Futures Commission v Young Bik Fung & Ors* as justification.[4] In that case, the Hong Kong based defendants dealt in shares of a bank listed on the Taiwan Stock Exchange with insider knowledge. However, the fact that the shares were not listed in Hong Kong meant that the SFC had to rely on section 300 of the SFO to prosecute the defendants. Section 300 criminalizes fraudulent or deceptive acts, practices, schemes, or devices. The difficulty of using section 300 in an insider trading case, however, is that section 300 is designed to cover transactions involving specific persons rather than conduct that impacts the integrity of the financial market as a whole.

The SFC has further cited an example of a matter in which it was unable to take enforcement action against a Hong Kong licensed intermediary who dealt in the securities of an overseas-listed entity ahead of the announcement of a placing exercise, when in

possession of inside information released to them by another licensed intermediary based in Hong Kong. This was on the basis that although the acts relating to the offence, except for the mechanics of trading, were committed in Hong Kong and the suspect's conduct appeared to fall within section 300, the SFC did not have sufficient evidence to establish that the suspect had engaged in any fraudulent or deceptive acts in the relevant transactions, and therefore no action could be taken under section 300.

Finally, the SFC has also noted that the insider dealing laws of comparable common law jurisdictions such as Australia, Singapore and the UK govern both overseas conduct relating to securities of local issuers as well as local conduct relating to securities of overseas issuers, and that as such it is important to ensure that the SFO is aligned with those of other major common law jurisdictions and the other market misconduct provisions of the SFO. In particular, the SFC has noted that following the launch of Stock Connect, the proposed amendments would strengthen the SFC's regulatory powers in tackling insider dealing conducted in Hong Kong involving A-shares listed in mainland China. While not expressly noted by the SFC, the reverse is presumably also true and that this would strengthen the SFC's powers to tackle insider dealing in mainland China in relation to Hong Kong listed securities.

IV. Conclusion

The Consultation Paper proposes important changes to the SFC's enforcement regimes. If such changes are passed into legislation, they may have a significant impact on the enforcement landscape in Hong Kong. Interested parties are encouraged to submit written comments in response to the proposed amendments prior to the close of the consultation period on August 12, 2022.

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[1] *Consultation Paper on Proposed Amendments to Enforcement-related Provisions of the Securities and Futures Ordinance* (June 10, 2022), published by the Securities and Futures Commission, available at: https://apps.sfc.hk/edistributionWeb/gateway/EN/consultation/doc?refNo=21CP3

[2] *Securities and Futures Ordinance* (Cap. 571), available at https://www.elegislation.gov.hk/hk/cap571?xpid=ID_1438403472945_001

[3] *Pacific Sun Advisors Ltd & Anor v Securities and Futures Commission* [2015] 2 HKC, available at: https://legalref.judiciary.hk/lrs/common/search/search_result_detail_frame.jsp?DIS=97598&QS=%2B&TP=JU

[4] *Securities and Futures Commission v Young Bik Fung & Ors* [2019] HKC 254, available at https://legalref.judiciary.hk/lrs/common/search/search_result_detail_frame.jsp?DIS=112192&QS=%2B&TP=JU

The following Gibson Dunn lawyers prepared this client alert: William Hallatt, Emily Rumble, and Jane Lu.

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. If you wish to discuss any of the matters set out above, please contact any member of Gibson Dunn's Global Financial Regulatory team, including the following members in Hong Kong:

William R. Hallatt (+852 2214 3836, whallatt@gibsondunn.com) Emily Rumble (+852 2214 3839, erumble@gibsondunn.com) Arnold Pun (+852 2214 3838, apun@gibsondunn.com) Becky Chung (+852 2214 3837, bchung@gibsondunn.com)

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