Civil Enforcement of Securities Violations in Hong Kong Section 213 of the Securities and Futures Ordinance

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Overview

The SFC's ability to issue civil proceedings to obtain protective and remedial orders against persons asserted to have contravened the market misconduct provisions, independent and irrespective of whether criminal or tribunal proceedings are pending or contemplated, was emphatically affirmed by the Court of Final Appeal's judgment released on May 10, 2013 dismissing Tiger Asia's jurisdictional objection to the Commission's use of the section 213 procedure.

Tiger Asia's challenge has engendered much debate on whether the Securities and Futures Ordinance allowed the Commission independently to bring civil proceedings in respect of market misconduct. That issue has now been correctly resolved, but was in any event a distraction which has tended to obscure the broader significance of the section 213 procedure and its emergence as a central component of the Commission's enforcement strategy.

The section 213 jurisdiction is not confined to insider dealing and market manipulation but is broadly available to prevent and remediate breaches of Hong Kong's securities laws. It has been invoked in various scenarios – ranging from brokerage failure to listed company prospectus liability to the sale of hotel units – which share the common feature of investor protection and an alleged breach of securities legislation. There is every reason to expect that the jurisdiction will now be exercised or threatened robustly, frequently and across a wider range of alleged infringements. This includes:

- IPO prospectus liability, against issuers, directors and sponsors.
- Liability under the new statutory regime for disclosure of inside information.
- Insider dealing and market-manipulation.
- Fraud and misappropriation of assets.

The absence of a class action regime, and legal constraints on litigation funding, have to date prevented the emergence in Hong Kong of class or representative actions for alleged securities violations. But the Commission has the mandate and legal ability under section 213 to issue civil proceedings to seek recovery on behalf of investors and, although ultimately limited by resource constraints, increasingly will do so. Put simply, civil proceedings will become a more prominent feature of regulatory enforcement in Hong Kong.

The purpose of the section 213 procedure

Section 213 empowers the Hong Kong Courts on the application of the Commission to make a broad range of orders designed to remedy and prevent the recurrence of breaches of the Securities and Futures Ordinance, licensing terms and conditions and certain parts of the Companies and Anti-Money Laundering legislation. The legislation allows interim injunctive relief to be obtained when it appears to the Commission that a breach had or might occur. It allows final orders to be made, such as unwinding transactions and appointing receivers to collect and distribute assets, based on the Court's determination that a contravention has in fact occurred.

In the Tiger Asia decision, in the context of market misconduct, the Court of Final Appeal described the purpose of section 213 as follows:

> *"Section 213, on the other hand, provides remedies for the benefit of parties involved in the impugned transactions. They include injunctions and the appointment of receivers to secure property with a view to recovery by the victims of market misconduct, orders that particular transactions be unwound, orders declaring particular transactions to be void or voidable. In these proceedings, the SFC acts not as a prosecutor in the general public interest but as a protector of the collective interests of the persons dealing in the market who have been injured by market misconduct. Proceedings under s 213 are the public law analogue of actions for damages by individuals under s 305 rather than a substitute for a criminal prosecution or proceedings before the Market Misconduct Tribunal. They are plainly civil proceedings and therefore do not attract the protection afforded to criminal defendants."*

This is a clear endorsement of the Commission's ability to act in a representative capacity on behalf of a class of investors when bringing section 213 proceedings. The Court of Appeal judgment in the Tiger Asia litigation was to similar effect:-

> *"Notwithstanding the availability of civil remedies to individual investors, there may be cases where investors cannot be expected to take proceedings individually to enforce their legal rights … There may be circumstances where it would be eminently reasonable for proceedings to be taken by the Commission under s 213 for the investors' benefit."*

Hong Kong does not presently have a class-action regime. The Law Reform Commission recommended in May 2012 that class actions be adopted in Hong Kong, limited at first to consumer claims. The recommendation is being considered and progressed without any apparent urgency. Section 213 is meanwhile emerging as the primary mechanism for class redress in respect of securities violations. Regulatory resource constraints may mean that section 213 is typically deployed in cases involving more egregious failures, but having invested in two separate appeals to the Court of Final Appeal to establish this jurisdiction (Tiger Asia and Kayden) it is clear that the Commission intends to use it more broadly and frequently. As Mark Steward, the Commission's Head of Enforcement, observed in November 2012, section 213 was "*a little used provision which we have made a significant part of our strategy*."

The Commission's use and reliance on section 213 will not necessarily require the institution of court proceedings. We expect the threat of section 213 proceedings to become a feature of regulatory dialogue when negotiating with the Commission to settle securities and disciplinary infringements in cases involving investor losses, in much the same way as the investigation or institution of disciplinary proceedings against senior management formed a core part of the dialogue when settling structured product mis-selling investigations prompted by the recent financial crisis. It was and is precisely through this leverage that the Commission has insisted on compensatory payments in circumstances where it does not have any statutory power to require such payments.

In order to predict and manage regulatory enforcement risk, it is therefore important to identify the range of circumstances in which the Commission can be expected to invoke this procedure for the benefit of investors.

Case studies: situations in which section 213 has or may be invoked

We anticipate actual or threatened reliance on section 213 to become a regular feature in each of the following situations:-

Fraud and misappropriation of assets. Section 213 has historically been used by the Commission in these circumstances. There are a series of cases since at least 2004 in which section 213 orders have been sought and obtained involving failed or mismanaged securities brokerages and hedge funds. The Commission's objective is to freeze assets to prevent misappropriation or dissipation and, in serious cases, to appoint administrators or receivers to manage the business and protect the interests of clients and investors.

Market misconduct. The Commission first relied on section 213 in an insider dealing investigation in July 2007 when obtaining interim injunctive orders against Du Jun, the senior investment banker subsequently imprisoned for six years for dealing in the shares of CITIC Resources. It has since sought such orders regularly, both privately and publicly, to freeze the perceived proceeds of market misconduct. Under sections 281 and 305 of the SFO, market misconduct when established also attracts deemed civil liability to compensate any person who has suffered resulting pecuniary loss. This liability can also extend personally to management of institutions and corporations found to have consented or connived in the misconduct. Section 213 has since been deployed in various insider dealing investigations including Tiger Asia (short-selling after confirming participation in share placement), China Forestry (block disposal to institutional investors by CEO and major shareholder shortly prior to announcement of accounting irregularities) and Titan Petrochemicals (alleged disposal by senior employee in the knowledge of impending bond default). We expect increased focus on market manipulation. In a speech delivered in June 2012, Mark Steward commented that sophisticated manipulation is "*arguably more prevalent and more costly to participants than insider dealing*."

Initial Public Offerings. Listed company governance and disclosure has become a core regulatory enforcement priority. Directors, promoters and (pending amendment of the Companies Ordinance, following the recently concluded sponsor consultation) banks or corporate finance houses acting as sponsors are or will be subject to civil liability for untrue statements or material omissions in an IPO prospectus. Absent a class-action regime, section 213 will be the primary mechanism for investor redress. This has already been demonstrated in the case of Hontex International Holdings, in which $832 million of IPO proceeds were frozen in 2010 by a section 213 application. Administrators were subsequently appointed to manage a share repurchase which completed in 2012.

Disclosure of Inside Information. The new statutory regime for disclosure of price-sensitive information, effective January 1, 2013, is transformative in respect of regulatory and civil enforcement for late or inadequate disclosure. The listed company and its directors and chief executive are each liable to proceedings before the market misconduct tribunal based on alleged breach of statutory disclosure obligations. An adverse finding carries with it statutorily imposed civil liability under section 307Z of the SFO to any person for losses suffered because of those breaches. This framework directly supports representative claims under section 213. An instructive example is the USD2 billion of currency derivative losses announced by CITIC Pacific in October 2008, some six weeks after the issue was first identified which, when announced, resulted in a 55% fall in share price. Under the statutory disclosure regime, this fact pattern could result in representative section 213 proceedings against the company and/or its directors to compensate investors who had acquired shares after the company first became aware of the exposure.

Alleged misfeasance by directors of listed companies. Directors or officers who have managed listed companies in a manner alleged to be prejudicial to shareholders are similarly exposed to claims under sections 213 and/or 214 of the SFO. For example, in August 2009, the Commission obtained a section 213 interim injunction against the former chairman of GOME Electrical Appliance freezing HKD1.6 billion based on the allegation that a share repurchase was carried out for the ulterior purpose of stabilizing the share price while the chairman disposed of his shares in order to repay a personal loan. More recently, in March 2012, the High Court made various protective and remedial orders against former directors of Styland Holdings Limited arising from concealed connected transactions causing financial loss to the company.

This list is not exhaustive. For example, the Commission announced on May 13, 2013 that the Cheung Kong Group had agreed to unwind the sale of hotel room units on the basis that the investment was a collective investment scheme regulated under the SFO. The Commission had otherwise threatened to issue section 213 proceedings, demonstrating that this jurisdiction will be broadly interpreted. Collective investment schemes and the distribution of authorized structured products are further examples of situations in which the Commission might have recourse to section 213 to bring civil proceedings to compensate aggrieved investors.

Concerns with and limits to the exercise of section 213

Section 213 allows wide-ranging and highly invasive orders to be made. The Commission, emboldened by the Tiger Asia decision, will have to exercise careful judgment to ensure that the jurisdiction does not operate oppressively and unfairly. Further recourse to the Hong Kong Courts may be necessary to clarify the limits of the statutory power. Some potential areas of concern or uncertainty are as follows:-

First, section 213(1)(b) empowers the Court to grant interim orders when it “appears to the Commission” that an actionable breach has occurred or might occur. This raises the question of to what extent (if at all) the Court is required to satisfied of an actionable breach. In the Kayden decision in December 2010, the Court of Final Appeal held that substantive orders would not be made “*merely on the basis of what appears to the SFC to be the position*”, but contrasted this with interim relief. We consider the correct position to be that the court, in the exercise of its discretion, must be satisfied at least to a prima facie standard that the evidence justifies interim relief. This interpretation is consistent with a speech delivered by Ashley Alder, the Chief Executive Officer of the SFC, in May 2012 when he observed in the context of section 213: “*The Court does not proceed on the SFC’s “say so”, and it is extraordinary to think that it might*.”

Second, there is an important question as to how soon in its investigation the SFC should seek section 213 orders. A practice appears to be developing of obtaining interim relief at the very outset, potentially before a case can be articulated. This may be appropriate in cases where there is justifiable concern that assets may otherwise be dissipated but otherwise risks oppression and unfairness. The analogy with a civil litigant seeking interim injunctive relief can only be taken so far. The SFC is a government agency with a range of powers available to obtain information and ensure that an intrusive application is sufficiently justified before it is brought. It can also backfire on the SFC, if the SFC’s characterization of the facts at any early stage proves materially flawed. See, for example, *SFC –v- Lee Sung Ho & Others, HCA 2177 of 2011*. Where the SFC does not seek interim relief, presumably the SFC would carry out a full investigation into the matter in the usual way, before commencing proceedings.

Third, insofar as representative claims are brought to compensate investors, it would be desirable for there to be a transparent and consistent framework for identifying and compensating investors, particularly in relation to dynamic listed markets in which there is a real risk that such schemes may operate in an arbitrary manner.

Conclusion

The Commission’s regulatory mandate, and the predominant focus of its regulatory enforcement program, is based on investor protection. Enforcement activity to date has principally been based on deterrence, including disciplinary sanctions for regulated persons and entities and criminal prosecution. It is now clear that the Commission does not regard deterrence of itself as a sufficient remedy, and that it intends to adopt a more activist and muscular approach to civil remediation. The section 213 procedure will become increasingly important as the Commission rebalances part of its enforcement activity to Hong Kong’s civil courts.

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