

# Client Update

## Hong Kong's Market Misconduct Tribunal Imposes Largest Ever Disgorgement Order

HONG KONG  
Mark D. Johnson  
mdjohnson@debevoise.com

### INTRODUCTION

On 23 June 2017, the Hong Kong Market Misconduct Tribunal (MMT) imposed the largest ever disgorgement order and a number of other penalties against the former directors and senior management of a listed company who had been involved in an “*edifice of dishonesty*” resulting in market misconduct.

In this bulletin, we take a look at:

- The risks for company directors and senior managers who fail to show the requisite “*strength of character*” to take on the “*onerous duties*” of a director of a listed company.
- The pitfalls of failing to prepare thoroughly for SFC interviews, including the risk that a person who is cleared of market misconduct may be unable to recover their costs due to their “*suspicious*” conduct.
- The policy considerations which underpinned the penalties imposed by the MMT.

### BACKGROUND

In December 2016, the MMT ruled that former executive directors of a GEM listed company, Greencool Technology Holdings Ltd (Greencool), had “*grossly overstated*” its net asset value in its accounts in a period between 2000 and 2004.

The fraud involved the inflation of assets and earnings of various subsidiary companies through the creation of fictitious business projects and fictitious income. Separate accounts were maintained and the accounts that reflected the

reality of Greencool's business affairs were withheld from outsiders, including Greencool's auditors.

This accounting fraud induced transactions (e.g. the purchase of Greencool shares by investors) and, consequently, the directors were found to have engaged in market misconduct contrary to section 277(1) of the Securities and Futures Ordinance (SFO).

Following a hearing, on 23 June 2017 the MMT imposed its largest ever disgorgement order of HK\$481,969,785. In this bulletin we look at the orders imposed by the MMT and consider the lessons from the MMT's decision.

## **ORDERS IMPOSED BY THE MMT**

### **Disgorgement Order**

Section 257(1)(d) of the SFO empowers the MMT to order that a person found culpable of market misconduct must pay to the Government an amount not exceeding any profit gained or loss avoided by that person.

In December 2016, the MMT had found "compelling" indirect evidence that Mr Gu Chujun (the former Chairman/CEO) of Greencool had played an active part in the fraud. Further, in 2001 Mr Gu acquired 80 million Greencool shares and subsequently disposed of 15 million of those shares.

Given Mr Gu's involvement in the fraud and market misconduct, the MMT was satisfied that it was proper to disgorge this profit. In determining the amount of the disgorgement, the MMT accepted expert evidence from the SFC that the disposals by Mr Gu gave him a profit of HK\$208,905,000 which, together with accrued interest (calculated at the judgment rate), made a total profit of HK\$481,969,785.

### **Disqualification Orders**

The SFC sought disqualification orders (pursuant to s. 257(1)(a) of the SFO) against the former executive directors of Greencool on the basis that they had "*been found not only to have known of the fraudulent activities taking place within the Greencool Group but played an active role in furthering those activities*". In order to protect the integrity of the market, the MMT had "no difficulty" in finding that each director should be disqualified for a maximum of five years.

### **“Cold-Shoulder” Orders**

Section 257(1)(b) of the SFO empowers the MMT to make an order prohibiting a person found culpable of market misconduct from dealing in securities or futures.

In reaching its decision to impose a cold-shoulder order against Mr Gu, the MMT noted that this power was protective in nature as well as a penalty against whom such an order is imposed. In particular, the MMT noted that such an order could be made to protect the integrity of the markets and that Mr Gu posed a “*very real threat to the integrity of the markets*” and, therefore, it was entirely appropriate to impose such an order against him for the maximum period of five years.

### **Orders Against the Company Secretary/Financial Controller**

The financial controller of Greencool was a qualified accountant appointed under the GEM Listing Rules and he was also the company secretary of Greencool.

The MMT found that the financial controller (FC) was negligent as to whether the information provided to the investing public was false or misleading and he was therefore culpable of market misconduct. In particular, he was negligent in performing his professional duties as a qualified accountant by failing to supervise the implementation of a sound internal control and financial reporting system, thereby enabling the executive directors to provide false and misleading annual results of Greencool which defrauded the investing public.

The SFC sought two orders against the FC:

- a director’s disqualification order under section 257(1)(a) of the SFO; and
- an order pursuant section 257(1)(g) of the SFO to refer the findings of the MMT to the Hong Kong Institute of Certified Public Accountants with a recommendation that it take disciplinary action against him.

With respect to the disqualification order, the FC argued that no disqualification order should be made because (i) he was found not to be an active and calculating participant in the fraud; and (ii) the culpability that had been found against him was that of negligence.

While the MMT accepted that the FC played no knowing role in the fraud, he had nonetheless held a position of high seniority as the financial controller and company secretary. The MMT found that the FC’s “*passive*” approach to his function effectively kept him from discovering the fraud and he failed in his

obligation to protect, promote and act in the best interests of the Greencool group as a whole.

This breach of professional duties called into question the FC's fitness to take on the decision-making role of a director of a listed company (even though he had not been a director of Greencool). Consequently, the MMT was "*firmly of the view*" that an order disqualifying him from taking on the role of a director of a listed company must be imposed. In particular, the MMT noted that "*his past conduct has shown that, until he has a full understanding of his own professional obligations, he simply lacks the strength of character and/or understanding of a director's duties to take on the more onerous duties of a director*".

With regard to the referral to the HKICPA to take disciplinary action against the FC, the MMT determined that a referral should be made because the scenario in which hostile directors threaten or seek to diminish the professional responsibilities of a senior financial officer in order to perpetrate an accounting fraud had wider significance to the profession. Consequently, the question of whether compliance with such a threat could undermine the integrity of the profession should be considered by the appropriate professional body.

### Costs

In view of their knowing involvement in the fraud, the MMT imposed an order requiring the executive directors of Greencool to each pay a portion of the majority of the SFC's costs and the FC was ordered to pay a lesser amount.

Notably, however, one of Greencool's independent non-executive directors (INED) who had been cleared of market misconduct, applied to recover her costs. In considering this application, the MMT noted that costs may not be awarded if it is satisfied that the person has caused the MMT to investigate or consider his conduct during the course of the proceedings in question (per section 260(4) of the SFO). In short, costs may not be awarded if the MMT is satisfied that, even though cleared of culpability, the person "*brought suspicion upon himself*".

In assessing this issue, the MMT noted that a "*good many matters relevant to the issue of whether the INED had been reckless or negligent in her capacity as an INED*" only emerged during the MMT proceedings and such matters had been omitted during the SFC's interviews of the INED. As a result, the SFC had been denied the opportunity to assess the case against the INED in its full context and the INED's answers to the SFC had prompted the institution of proceedings against her.

Despite accepting that there had been “*questionable shifts in emphasis*” in the INED’s evidence, the MMT did not accept that the INED had brought suspicion upon herself in this instance. In reaching this decision the MMT noted that:

- During the SFC’s interview, the INED was not informed that she was a person under investigation and that it was “*entirely understandable*” that, when her own culpability was put in issue, there were additions and differences of emphasis in her evidence compared to the SFC interviews. The MMT also noted that the INED had no duty to anticipate all possible cases against her.
- In circumstances where the INED was being asked to remember matters that had taken place more than a decade earlier, there were bound to be gaps in the memory and vacillation as to the true nature of otherwise long-forgotten conversations.
- An “over-eager” defence of the INED’s reputation which may have distorted her own sense of objectivity did not result in the MMT disbelieving the substance of her evidence.

### COMMENT AND TAKEAWAYS

In a region where accounting issues (and the market abuses which may arise from such issues) are a prominent risk factor for investors, it is notable that the protection of the integrity of the market underpinned the reasons given for a number of the orders made by the MMT. It is therefore perhaps reassuring to investors that, in order to preserve the integrity of the markets (and, equally, to deter similar misdemeanours), the MMT had no difficulties in imposing the maximum possible penalties on individuals culpable of market misconduct arising from active involvement in an accounting fraud of a listed company.

There are also a number of key takeaways for company directors and senior managers. These include:

- The decision by the MMT underlines the need for directors and senior management to actively comply with their professional duties. Individuals who culpably fail to discharge their professional duties may be found to be unfit to act as directors of listed companies (including senior management who were not acting as directors at the time of the relevant wrongdoing).
- The criticism of the INED’s evidence and the allegation that she had brought suspicion on herself reinforces the need for directors and senior management to:

- Keep careful records of their activities in order to evidence the steps they have taken to discharge their professional duties. This could include, for example, ensuring that debates about company matters are properly reflected in board minutes.
- Prepare thoroughly for interviews by the SFC to ensure that the evidence is as complete as possible. This approach should be adopted regardless of whether the person is under investigation at the time, as incomplete or inconsistent evidence may prompt the SFC to institute proceedings.

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Please do not hesitate to contact us with any questions.