The Securities and Futures Commission ("SFC") published a new Guidance Note on Cooperation with the SFC on 12 December 2017 ("Guidance Note"), with FAQs. The Guidance Note has elaborated the SFC’s approach to cooperation in disciplinary, civil and Market Misconduct Tribunal ("MMT") proceedings. The Guidance Note does not affect criminal cases in which the Department of Justice retains unfettered discretion.

To encourage early cooperation and resolution of cases, the SFC has divided the disciplinary process into three stages. It has capped the reduction of sanction that a regulated person may receive for cooperating and resolving proceedings by entering an agreement ("section 201 Agreement") under section 201 of the Securities and Futures Ordinance ("SFO") at each stage as follows:

- Stage 1 – from detection of the misconduct up to the issuance of the Notice of Proposed Disciplinary Action ("NPDA"), credit of up to 30%
- Stage 2 – from issuance of the NPDA up to the deadline for submitting written submissions in response to the NPDA, credit of up to 20%
- Stage 3 – from the deadline for the response to the NPDA to the issuance of the Decision Notice, credit of up to 10%

The Guidance Note also highlights that the SFC will be more willing to enter a section 201 Agreement for disciplinary matters if cooperation is demonstrated by the commissioning of third-party reviews and provision of directors’ undertakings.

Further reductions may be possible where exceptional or substantial cooperation was given by the regulated person. However, the SFC is unlikely to consider resolving disciplinary matters on a private or "no admission of liability" basis.

**So what’s new?**

The previous March 2006 Guidance Note provided for a maximum reduction of the sanction, in the absence of extraordinary circumstances, by one order of magnitude, or 33%, irrespective of what stage a section 201 Agreement was reached, or when the SFC’s proposed findings or sanctions were accepted. By telescoping the credit received after the NPDA to 20% and 10%, the SFC seems to be encouraging early resolution in appropriate cases. Recent
decision notices and the FAQs suggest, however, that the SFC tends to favour third-party reviews as a precursor to any resolution on the basis that the review demonstrates the necessary cooperation. In practice, this may mean that the SFC is delegating much of the initial investigative work to the firms who carry out these third-party reviews to focus its resources on other priority cases.

Although the calculation of disciplinary fines remains an art and not a science, the Guidance Note states that the SFC will indicate the level of reduction in sanction to those being disciplined and describe the level of cooperation in the press release and decision notice, a practice which it has been adopting over this last year.

**What amounts to cooperation?**

At the risk of stating the obvious, producing documents or attending interviews in compliance with sections 179 or 183 notices issued by the SFC under the SFO does not amount to cooperation, nor does compliance with self-reporting obligations. Cooperation may be demonstrated by conduct such as:

> Voluntarily and promptly reporting any breaches to the SFC
> Providing true and complete information regarding the breaches by, for example, taking early and proactive steps to preserve and collect important evidence and providing it to the SFC, making full and frank disclosure to the SFC including the results of internal investigations, providing useful intelligence to the SFC, providing oral testimony in proceedings, reporting problems occurred overseas to the SFC, disclosing relevant documents located outside Hong Kong and facilitating production of documents and witnesses from outside Hong Kong
> Taking responsibility for the breach, by demonstrating a willingness to address the SFC’s regulatory concerns and taking a proactive approach to bring the matter to an early conclusion
> Taking rectification measures to contain the breaches, making full and prompt compensation to affected investors and instituting enhancements to internal controls

**How is cooperation measured?**

In assessing cooperation, the SFC will consider factors such as:

> The value of the assistance provided, for example the timeliness, the quality, extent and substance of the assistance provided, whether the investigation was initiated by the SFC because of cooperation and the time and resources conserved by the SFC as a result
> The nature and seriousness of the breaches and their impact on the market
> The general conduct of the party after the breaches and other circumstances of the party

The SFC stressed that uncooperative conduct, for instance, failing to promptly and fully report a material breach, withholding information relating to a breach, engaging in evasive conduct during an investigation and arranging affairs with
the intention of unnecessarily prolonging SFC’s investigation, will be taken into account when considering the appropriate outcome.

Whilst a refusal to waive legal professional privilege will not be regarded as uncooperative, voluntarily waiving privilege, even on a limited basis, may be regarded as cooperation.

**Disciplinary matters**

The SFC may be more willing to enter into a section 201 Agreement to resolve disciplinary proceedings at an early stage if a firm commissions a third-party review jointly with the SFC. The SFC expects the firm to bear the cost of the reviewer, to allow the SFC to devise the terms of reference and to accept the reviewer’s findings. In this respect, it is important to note that the Guidance Note states that the firm will generally not be entitled to review the reviewer’s report before it is provided to the SFC, or to request that changes be made to the report. On its face, this approach does not seem to accommodate public law natural justice considerations where the reviewer may have fallen into error\(^1\). The SFC also expects the firm to give the SFC rights to access the review findings, to permit the SFC to use the reviewer’s findings of fact as the basis for appropriate disciplinary proceedings (a delegation of the SFC’s public law duties\(^2\)), and implement remedial measures advised by the SFC and the reviewer.

The giving of directors’ undertakings\(^3\) to address the SFC’s regulatory concerns will also be regarded favourably. These may include undertakings to remedy deficiencies identified in a third-party review and to ensure such failings do not recur (see for instance the first such undertaking in the resolution with the SFC by Merrill Lynch Far East Limited in March 2017).

**Civil and MMT proceedings**

The Guidance Note contains a new section on cooperation in civil proceedings, where a party may resolve matters with the SFC by reaching agreement on facts and the period of disqualification with the SFC, which are then submitted to the court for determination. Similarly, in MMT proceedings, a party may resolve matters with the SFC by agreeing to sign a statement of agreed facts and on the proposed orders. The SFC may agree to a reduced proposed sanction and mitigation submissions in support of the proposed orders in such circumstances. Whilst the court and the MMT are not bound to accept the orders put forward, they may give weight to the fact that the proposed orders have been agreed. The SFC may also issue a cooperation letter to another regulator if requested by the party.

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\(^1\) Note that in the UK, the question of whether a “skilled person” review is an exercise of a public law function amenable to judicial review is due to be heard by the Court of Appeal this month in *Holmcroft Properties v KPMG LLP* [2016] EWHC 323 (Admin)

\(^2\) The SFO contains no equivalent of the statutory power in section 166 of the Financial Services and Markets Act in the UK that gives the FCA power to commission a report by “skilled persons”.

\(^3\) There is no express power in statute or regulation for the SFC to require such undertakings.
Commentary – policy from the UK

The Guidance Note and FAQs make clear that the SFCC will continue to favour third-party reviews to tackle systemic problems, and often address multiple systemic shortcomings in one resolution. The SFCC says its philosophy is intended to target these systemic issues and to deploy its resources effectively. In practice, this approach to cooperation informs the SFCC’s changed approach to investigations that now often involve third-party reviews.

The Guidance Note seems to be aimed at encouraging settlement in appropriate cases at Stage 1 before the NPDA, although the use of third-party reviews and the need for the SFCC to build a case may mean that resolutions in some circumstances may not occur any earlier than is currently the case.

Interestingly, the Guidance Note’s approach to telescoping credit for cooperation through the three stages leading to the issuance of a decision notice appears to borrow from the FCA’s previous discount scheme in the Decision Procedures and Penalties Manual (“DEPP”) 6.7 where a 30% discount was available at Stage 1 (prior to the UK NPDA equivalent), 20% at Stage 2 (prior to the deadline for representations) and 10% for Stage 3 (prior to the deadline for a decision notice). That discount scheme was abandoned by the introduction of its new Focused Resolution Agreement scheme under DEPP 6.7 in March 2017 (partly because so few cases were settling in Stage 2 or beyond). Time will tell whether the level of settlements in Hong Kong at Stages 2 and beyond may mean further changes to the Guidance Note are required.

As with the use of third-party reviews and directors’ undertakings, this is a further example of the SFCC tailoring FCA practices for the Hong Kong market.
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