

# Challenging the SFC: What Every Compliance Officer Needs to Know

*Licensed and registered persons generally prefer to work with the SFC rather than against the SFC. Nevertheless, circumstances may arise where the SFC adopts a hostile posture or takes a position that is commercially undesirable. While it is the rare licensed or registered person who is unafraid to challenge the SFC, the past 4 years have demonstrated that where the SFC acts unreasonably, in bad faith or otherwise improperly, a remedy may be available through the SFAT. In this article, we review strategies for challenging the SFC through the SFAT.*

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**T**he Securities and Futures Commission (“SFC”) interacts with licensed and registered persons in 2 key ways. First, it regulates their conduct of business, bringing enforcement action where it considers that they have breached applicable laws or regulations. Secondly, it acts as a gatekeeper for new investment products and services.

In these 2 respects, the powers of the SFC are broad. In the absence of a final disciplinary decision, it is the rare licensed or registered person who is unafraid to challenge the SFC in the exercise of its discretion and to risk damaging its ongoing relationship with the SFC.

However, the experience in the past 4 years demonstrates that if nothing else, the SFC is subject to the constraints of the law. Where

it acts unreasonably, in bad faith or otherwise improperly, it may be successfully challenged through the Securities and Futures Tribunal (“SFAT”). Consequently, whilst no decision to challenge the SFC in an open and adversarial manner should be taken lightly, the option to challenge the SFC should not be ignored.

## Background

The SFAT is constituted under the Securities and Futures Ordinance (“SFO”). As set out in the Government’s original Consultation Document on the SFO, the SFAT is intended to be “independent of the SFC”, to provide a “full merits” review of SFC decisions and to act as “a powerful safeguard in ensuring that... SFC decisions are correct, proper and fair.”

## Independence of the SFAT

The SFAT comprises a judge and 2 lay members. No member of the SFC sits on the SFAT.

## Powers of the SFAT

Under the SFO, the SFAT has the power on review of an SFC decision to confirm, vary or set aside the SFC's decision and, where the decision is set aside, to substitute for that decision any other decision which the SFAT considers appropriate. In this regard, the SFAT may make any decision, whether more or less onerous, than the SFC had the power itself to make in respect of the person making the application for review.

The SFAT also has the power to remit any matter in question to the SFC with directions it considers appropriate, which may include a direction to the SFC to make a decision afresh in respect of any matter specified by the SFAT.

## Approach of the SFAT

Based on judicial precedent, on a review of a case decided by the SFC, the SFAT is required to hear the case anew and decide the case for itself based on such a re-hearing. It is not bound by the decision of the SFC and may, therefore, vary or set aside a decision of the SFC even if the decision of the SFC is not defective by reason of procedural or jurisdictional error.

Thus, unlike judicial review, the SFAT may vary or set aside the decision of the SFC on the simple basis that it does not agree with the views expressed by the SFC. However, it is obliged to give due weight to the fact that the SFC is the regulator and should, accordingly, be slow to vary or set aside the de-

cision of the SFC unless it decides that the SFC decision is wrong (rather than simply not right). Regrettably, the line between the SFC decision being wrong and simply not right is not clear though, in the event of a procedural or jurisdictional error, it is likely that the SFC decision will be wrong.

In hearing the case anew, the SFAT is not limited to reviewing the reasons given by the SFC for their decision. It may examine the original evidence presented before the SFC when the SFC reached its original decision as well as new evidence, new submissions, the decision making process of the SFC, any policies applied by the SFC or any other relevant matter.

## SFAT Strategies

Since its inception in April, 2003 to the date of this article, the SFAT has determined and provided written reasons for 24 cases. From these cases, a number of lessons emerge. Chief among these is that successful appeals against SFC decisions have usually relied upon one or more of the following grounds:

- failure to consider the individual merits of a case;
- bad faith on the part of the SFC;
- erroneous or outdated findings of fact; or
- absence of a specific rule or policy to justify the SFC's position.

Conversely, arguments premised on mere incorrect exercise of discretion by the SFC have been almost uniformly unsuccessful. Such arguments are more likely to result in threats of sanctions against the applicant than in reversal of the underlying SFC decision.

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### Failure to Consider Individual Merits of Case

It is a general principle of administrative law that a regulator must consider the unique facts of each case before it or its decision is subject to reversal. Consistent with this principle, the SFAT has interfered with SFC decisions where it considered that the SFC had pursued its general policy or practice without regard to specific circumstances.

### Bad Faith

Another general principle of administrative law is that a regulator must act within the bounds of natural justice. While the SFAT is understandably reluctant to use the 'bad faith' label in its published decisions, it has occasionally questioned the motivation behind certain SFC decisions and ruled accordingly.

Of particular significance, in Application 2 of 2004, the SFAT hinted that the SFC had let a history of bad blood between the parties cloud its judgment in handing down penalties that were overly harsh. The SFAT accordingly reduced the penalties from revocations of the two Applicants' licenses to one-month suspensions plus fines of HK\$50,000.

### Findings of Fact

Findings of fact made by the SFC, particularly those which underpin its decisions, may be challenged through the SFAT. Indeed, the SFAT has broad powers to collect evidence including through *viva voce* witness testimony before the SFAT.

In this regard, the SFAT is on equal footing with the SFC whereas in

respect of regulatory policy and the application of such policy, the SFAT is obliged by law to be deferential to the views of the SFC.

### Absence of Specific Rule or Policy

Decisions of the SFC premised on general principles may be more susceptible to successful challenge before the SFAT than decisions premised on specific requirements. This is particularly so where the SFC applies general principles to prohibit conduct where no specific prohibition has been published, the prohibition has not been the subject of public consultation and the desirability of such a prohibition is an issue upon which reasonable men may differ.

In Application 8 of 2006, for instance, the SFC sanctioned the Applicant for recommending to a client a "locking" strategy. "Locking" involves taking equal long and short positions on a futures contract to avoid margin calls should losses occur.

The SFAT wondered why, if the practice was as deceptive as claimed by the SFC, the SFC had taken no steps "to make it explicit to market participants that this practice will not be tolerated save in exceptional circumstances". The SFC had no answer to this question and so the SFAT reduced the Applicant's sanction. The sanction might have been lifted in its entirety but for the existence of a separate cold-calling finding by the SFC against the Applicant which was not challenged on appeal to the SFAT.

### Incorrect Exercise of Discretion

In a handful of cases, applicants for review have successfully chal-

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lenged SFC decisions on the basis that the SFC has not exercised its discretion correctly. However, challenges of SFC decisions which do not bring out new evidence or new submissions, which do not cast the evidence in a new light and which do not impugn the decision making process of the SFC are difficult (though, as the record shows, not impossible) to mount successfully.

## Product Innovation and the SFAT

One area where the SFAT has been historically inactive is in challenging SFC action (or inaction) in new products. All 24 cases to date have arisen because of dissatisfaction with SFC licensing related decisions, including, for example, decisions to discipline a licensed person, to refuse a license to an individual or to impose a condition on a license of a licensed person. However, the jurisdiction of the SFAT is much broader than this case history suggests.

### SFAT Jurisdiction in Respect of Investment Products

In respect of new investment products, the SFAT may review cases relating to refusal of the SFC to authorize the issue of any advertisement, invitation or document or the imposition by the SFC of any condition in respect of an offer or invitation to the public to acquire, dispose of, subscribe for or underwrite securities.

In light of anecdotal evidence of industry frustration as to perceived rigidity in the approach taken by the SFC to authorization of innovative investment products, it is surprising that to date no challenges have been raised to

the SFAT in respect of the refusal of the SFC to authorize a collective investment scheme. It is possible that the financial industry is simply unaware of the SFAT as an avenue of review or, as noted earlier, is fearful of perceived adverse repercussions in challenging the SFC through the SFAT.

### Challenging Prolonged Delay and Overzealous Vetting

However, a more practical explanation may be that the new product sponsors simply never reach the stage where discussions with the SFC in respect of the product end and a decision of the SFC is made.

Two questions arise in such instances, namely:

- whether, in the absence of a final decision from the SFC, it is possible to engage the SFAT to make an interlocutory ruling so as to progress the matter, and
- if so, whether it would be wise to force the SFC's hand by taking the matter to the SFAT.

### Expanded Construction of Specified Decisions

Under the SFO, the SFAT only has the jurisdiction to review a "specified decision". In the case of a new product, a "specified decision" includes a "refusal to authorize the issue of any advertisement, invitation or document" which is or contains an invitation to the public to enter into an agreement to acquire or subscribe for securities.

On its face, it is arguable that a specified decision is a final decision. However, the SFO itself does not expressly provide that the de-

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cision must be final. Accordingly, it may be possible to treat communications with the SFC prior to a final decision (e.g. an SFC request for information) as a *de facto* decision not to authorize the marketing materials for the product without the information and to seek SFAT review for that decision on the same grounds as any other.

While the matter is not beyond doubt, there are good reasons to believe that the SFAT would, or should, agree to treat a communication from the SFC prior to a final decision as a specified decision within the meaning of the SFO.

#### SFAT Jurisdiction Not Limited to Actual Decision

At the outset, it is significant to note that the jurisdiction of the SFAT is not limited to reviewing the actual decision of the SFC to refuse authorization.

In *Berich Brokerage Limited and Securities and Futures Commission*, [2005] 2 HKLRD 583, the applicant alleged impropriety on the part of SFC staff in the conduct of an SFC investigation into the applicant. As a result of the allegations, the SFC conducted an internal inquiry which found no wrongdoing on the part of its staff. Once the inquiry completed, the SFC imposed disciplinary sanctions on the applicant.

The applicant challenged the propriety of the SFC's internal inquiry through judicial review. The Court refused judicial review to the applicant holding that because the internal investigation was tangentially connected to an SFC licensing decision, jurisdiction to determine whether the internal

investigation was properly conducted belonged to the SFAT.

Whilst in this case there was a final decision made by the SFC, it is notable that the Court held that the jurisdiction of the SFAT was not limited only to the actual disciplinary decision but also included matters precedent to the disciplinary decision.

#### No Unreasonable Delay

If matters precedent to a decision of the SFC are properly within the jurisdiction of the SFAT, it presumably follows that unreasonable delay and other procedural error on the part of the SFC in reaching a decision lies within the jurisdiction of the SFAT.

Administrative law provides that a regulator must act without unreasonable delay. Failure to act within a reasonable time may result on judicial review in a court issuing a writ of mandamus directing the regulator to take the action in question.

From a policy perspective, it is desirable for the SFAT to assume jurisdiction in the event of unreasonable delay on the part of the SFC in making decision. One underlying purpose of the SFAT is to supplant the need to seek remedy through judicial review in the courts. If the SFAT did not have jurisdiction to address procedural and substantive matters such as unreasonable delay ahead of a final decision, this purpose would not be served.

In an extreme case, this would mean that the SFAT would not have the jurisdiction to entertain a review even if the SFC unreasonably and in bad faith deliberately refused to make a final decision.

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## Advantages of Resorting to SFAT Before Final Decision

If the SFAT does have interlocutory jurisdiction (*i.e.* jurisdiction to review decisions of the SFC precedent to a final decision as to whether or not to authorize marketing materials for a new investment product), sponsors of new products may be able, whether gently or forcibly, to progress authorization applications more quickly:

- the SFC may be subject to review by the SFAT if it takes an unreasonable time to consider applications;
- the SFC may be subject to review by the SFAT if it requests information which is not, viewed objectively, relevant to an application;
- the SFC may be subject to review by the SFAT if it follows a general policy without sufficient regard to individual merits of the application; and
- the SFC may be subject to review by the SFAT if it im-

poses conditions on authorization which, viewed objectively, are unreasonable.

This is not to say that resort to the SFAT will necessarily result in authorization. The SFAT is highly unlikely to make a decision to authorize marketing materials for a product

However, in cases where there is significant delay or the product sponsor considers that the SFC is acting unreasonably, the SFAT may be a viable option. Particularly if the SFAT has jurisdiction prior to a final decision, a product sponsor may be able to define the relevant issues and the appropriate range of regulatory responses to those issues through the SFAT. At the same time, the product sponsor can continue to work with the SFC following an SFAT hearing to continue to progress the application, no final decision having been made.

## Conclusions

The SFAT's work in the past 4 years demonstrates that the SFC

is subject to real constraints under the law, particularly where it fails to consider the individual merits of a case, where it acts in bad faith, where it proceeds on erroneous facts or where it acts in the absence of specific rules.

While much of the SFAT's work has focused on licensing and licensing related matters, licensed and registered persons may wish to bear in mind that the SFAT is available as a means to challenge the SFC on a wide range of decisions, including new product authorizations. ■

*TIMOTHY LOH, SOLICITORS serves as Hong Kong and International Legal Counsel to financial institutions. Since its establishment in 2004, its clients have included 10 financial institutions ranked in the FT Global 200 and it has been recommended each year by the Asia Pacific Legal 500 for its financial services and regulatory practice.*

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