

Responding to SFC Enforcement Action: New Tactics?

A recent decision of the Hong Kong Court of Appeal has raised the issue of whether disciplinary proceedings against licensed and registered persons are civil or criminal in nature. While a subsequent decision of the SFAT has ruled that such proceedings are civil, the current state of the law remains unsettled with at least the possibility of a higher standard of proof available in certain instances. In this article, we examine these developments, and more importantly, what the repercussions could be for licensed and registered persons who find themselves in the crosshairs of the SFC.

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The Securities and Futures Ordinance (“SFO”) establishes the framework by which licensed or registered persons are regulated. Where they misconduct themselves, it provides for them to be disciplined and, in some cases, subjected to criminal proceedings or proceedings before the Market Misconduct Tribunal (“MMT”).

Under this framework, disciplinary sanctions may be imposed on licensed and registered persons for conduct which may also serve as the subject of criminal offences. Perhaps more significantly, disciplinary sanctions in such cases may exceed criminal sanctions, even though the legal rights afforded to defendants in disciplinary proceedings are far fewer than those afforded in criminal proceedings.

In principle, this is wrong. Indeed, the recent decision of the Court of

Appeal in *Koon Wing Yee v. Insider Dealing Tribunal* suggests that legal rights afforded to defendants in disciplinary proceedings may be more extensive than those currently afforded to them.

The Koon Decision

In *Koon*, the Court of Appeal held that proceedings before the Insider Dealing Tribunal (“IDT”) were criminal in nature even though the legislature had classified them as civil proceedings under the now-repealed Securities (Insider Dealing) Ordinance. As a result, the targets of those IDT proceedings were entitled to the protection of Articles 10 and 11 of the Hong Kong Bill of Rights (“HKBOR”), including the right against self-incrimination and the heightened criminal standard of proof.

Consequences of *Koon*

The *Koon* decision opened up the possibility of litigation in relation to whether enforcement proceedings designated by the legislature as civil can retain that classification or should now be regarded as criminal.

Challenges based on *Koon* have been raised before both the MMT and the Securities and Futures Appeal Tribunal (“SFAT”). Although those challenges were rebuffed, with at least the MMT ruling now the subject of judicial review, they offer guidance for how licensed and registered persons faced with disciplinary proceedings under the SFO may proceed in the future.

The Three Criteria

Based on *Koon*, 3 factors determine whether proceedings are criminal or civil in nature:

- the characterization of the offense under domestic law;
- the nature of the offense; and
- the nature and degree of severity of the penalty.

The Characterization of the Offense

The SFO classifies disciplinary proceedings as civil in nature, establishing that it is sufficient for the SFC to be satisfied on the standard of proof applicable to civil proceedings in a court of law that a licensed or registered person has contravened the SFO or any requirement made thereunder.

However, as the court noted in *Koon*, the classification of disciplinary proceedings as civil in nature is the least important of

the 3 factors. Thus, in *Koon*, the court decided that insider dealing proceedings were criminal even though the legislature had classified them as civil. If it were otherwise, the legislature could create offenses punishable by incarceration and then insulate them from judicial scrutiny and the protections available in criminal proceedings merely by classifying as civil.

The Nature of the Offense

Disciplinary sanctions serve 2 purposes, the first being to protect the public and the second being to punish a licensed or registered person for misconduct. Under *Koon*, the nature of an offense will tend to be civil where sanctions are imposed primarily to protect the public but criminal if the sanctions are primarily intended to punish the offender.

There is also a moral component involved in establishing the nature of the offense, although it is often given less weight than the purpose of the sanctions; the *Koon* decision looked both to the element of dishonesty involved in the offense of insider dealing and to the fact that insider dealing is treated as a crime by many jurisdictions.

The Nature and Degree of Severity of the Penalty

The nature and degree of severity of a penalty includes consideration of whether an offense may result in incarceration or other loss of liberty. Generally, the loss of one’s ability to practice a chosen trade (for example, as a broker) is not likely to be regarded as a loss of liberty.

However, the prospect of a significant financial penalty may cause proceedings to be criminal

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in nature. This is so even if the penalty is calculated by reference to the profit made or loss avoided. Thus, in *Koon*, the fact that insider dealing could be punished by a fine of up to 3 times the amount of profit made or loss avoided resulted in a finding that proceedings before the IDT were criminal in nature.

Response to *Koon*

The initial response to *Koon* has been tepid. The MMT has ruled that MMT proceedings are civil in nature. Similarly, the SFAT has ruled that disciplinary proceedings are civil in nature but that the applicable standard of proof is subject to a sliding scale of legal protection.

SFAT Decision

In holding that disciplinary proceedings were civil in nature, the SFAT relied on 2 points. First, the SFAT noted disciplinary proceedings are not of general application. Instead, they are limited to a restricted group (*i.e.* licensed or registered persons). Accordingly, based on English judicial precedent, they are unlikely to be classified as criminal unless they may lead to a loss of liberty.

Secondly, the SFAT found that disciplinary proceedings are concerned with both punishing offenders and protecting the public. Consequently, disciplinary proceedings are not necessarily criminal in nature.

However, the fact that disciplinary proceedings may be civil in nature does not mean that protections afforded criminal proceedings are necessarily absent. The sliding standard of proof mentioned above, reflecting the maxim that

graver allegations require weightier proof, is one example of heightened protections available in a so-called civil proceeding. Ultimately, depending on how the *Koon* factors are applied in any given case, other criminal protections, particularly those implicated under the HKBOR, could come into play.

Practical Implications

Because the *Koon* criteria must be applied on a case-by-case basis, the SFAT decision cannot be read as support for the proposition that all disciplinary proceedings will be regarded as civil. Moreover, the SFAT is not a judicial body and its decisions are subject to review. Thus, some uncertainty remains.

In the right case, it may be possible to secure a criminal classification for certain proceedings, and the procedural protections that go along with such a classification. Even if not, it may be possible to press for greater legal rights including the application of a higher standard of proof, analogous if not identical to the criminal standard.

Arguing for a Criminal Standard

While there is judicial authority that a disciplinary proceeding is unlikely to be classified as criminal unless it involves or may lead to a loss of liberty, we do not believe that this means that disciplinary proceedings will never be classified as criminal.

Discipline in lieu of Criminal Prosecution

In particular, in a disciplinary proceeding, where the misconduct

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may also be prosecuted as a criminal offence under the SFO and the penalty proposed would exceed that available through the criminal proceedings, there is a compelling argument that the disciplinary proceeding should be treated as criminal. It is anomalous that where misconduct is prohibited as a criminal offence, disciplinary proceedings with fewer legal protections can be taken to punish that misconduct with sanctions which exceed those customary for the criminal offence.

In this regard, there have been a number of disciplinary and criminal proceedings in relation to unlicensed dealing in securities. In these cases, the sanctions imposed on a disciplinary basis have far exceeded those imposed on a criminal basis. For example, in one disciplinary case, a representative of a global financial institution was fined HK\$287,372 by the SFC for dealing in securities without a license for a period of approximately 2 months. In contrast, in a different case prosecuted as a criminal offence, a bank was fined a mere HK\$40,000 for dealing in securities without a license for a period of approximately 6 months.

The most striking aspect of the contrast in the size of the penalties in these cases is that in the disciplinary case, the SFC specifically

found that the public had suffered no harm as a result of the representative's actions. In other words, the fine was designed to punish the representative rather than to protect the public.

Under the criteria above, such disciplinary proceedings ought to have been classified as criminal since:

- unlicensed dealing in securities is a criminal offence,
- the fine was designed to punish the representative rather than to protect the public, and
- the fine's amount was far greater than what would likely have been imposed in a criminal proceeding.

Consequences of Criminal Classification

If a disciplinary proceeding is treated as criminal rather than civil in nature, the following consequences may arise:

- the SFC may lose the right to compel or use testimony of a self-incriminatory nature;
- the SFC may lose the right to rely upon hearsay testimony and to shield witnesses from cross-examination;
- the SFC may have to meet

the higher criminal standard of proof; and

- the SFC may have to comply with the legal protections afforded to defendants under the HKBOR.

Falling Back on the Civil Standard of Proof

Even if disciplinary proceedings are treated as civil in nature, the evolving law in this arena promises to provide an increasing number of opportunities for legal counsel to assert legal rights normally afforded only in criminal proceedings.

In particular, the recent MMT and SFAT decisions have reiterated the sliding nature of the civil standard of proof and have left the possibility open that in certain disciplinary proceedings, the civil threshold may approach or even be identical to the criminal standard. ■

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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