

## Hong Kong's compliance officers on alert after five-year ban imposed on short seller

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The recent five-year ban from Hong Kong's securities regulator against the founder of U.S.-based short-seller Citron Research for market manipulation, should put compliance and legal staff on heightened alert, officials said. Vetting and reviewing published research materials that could be construed as false or misleading will be critical in future, lawyers in Hong Kong and London said of the decision of the Market Misconduct Tribunal (MMT).

"Compliance and legal staff of banking and financial institutions in Hong Kong, therefore, must put themselves on a heightened sense of alert in vetting and reviewing published research materials which might be considered as false or misleading and inducing transactions in securities," said Andrew Wu, a partner at Norton Rose Fulbright in Hong Kong.

The MMT found U.S.-based Andrew Left culpable of market misconduct in connection with his research report ("Left's Report"), published on June 21, 2012, on his Internet Citron Research website. The report at issue concerned the Hong Kong-listed, mainland Chinese property developer company, the China Evergrande Group.

In an email to Reuters News, Left said he planned to appeal: "I do not believe the decision properly reflected the case, I did an extensive amount of research and am disappointed that the courts have stifled my freedom of speech."

Few were swayed by Left's freedom of speech argument.

"This case is not about freedom of speech, it is about responsibility of speech. The duties attendant on publishing research opinion into a reactive market are becoming more discriminating, particularly where the information provider is also a position-taker," said Syren Johnstone, adjunct associate professor of law at the University of Hong Kong.

Hong Kong regulators believe freedom of speech is a right to be used responsibly, especially when such speech has the power to move markets, sources said. For example, in the present case, the MMT did not accept that so long as the report of an analyst is based on publicly available information, that they were free to draw conclusions that were false and misleading.

"Bearing in mind the speed and fluidity of financial markets, said the MMT, there must always be a danger that false or misleading information, especially as to complex issues, may have a materially detrimental impact on the market before its

true nature is understood and becomes known," Wu said.

"The standard of care, according to the MMT, is the level of care to avoid the inclusion of false or misleading information as to material facts that is realistically required of a reasonably prudent person carrying out the function of a market commentator or analyst. According to this standard, an analyst is expected to have checked his information with both an expert and the company the stocks of which are being analysed before publishing his commentary," he said.

In a separate March 2016 decision by a different tribunal, the Securities and Futures Appeals Tribunal (SFAT) held that the use of "misleading and unfair" language in a report was a breach of the SFC's Code of Conduct, resulting in a fine against Moody's Investors Service, the ratings agency.

In another local case, the managing director of a leading investment bank was found guilty of insider dealing. As adviser of a transaction, he was deemed an insider by regulators.

"The present case evinces that the SFC is widening its net and could go after people who are not insiders by using other provisions of the Securities and Futures Ordinance (SFO) relating to market misconduct," said Mohan Datwani, a solicitor and director of technical standards at the Hong Kong Institute of Chartered Secretaries (HKICS).

### **Increased risk**

"The decision definitely enhances the risks for analysts. It just adds to the pressure, especially when you consider that some analysts are already under institutional pressure not to publish negative reports," said Abdulali Jiwaji, a partner at Signature Litigation in London. "One wonders whether regulators would look so closely if an analyst report including a buy recommendation caused an upsurge in the share price of a company," he said.

Appeals can be made on the basis the law was misapplied, or there was an error of fact.

The MMT also granted a "cease and desist" order against Left last week with respect to some activities, which puts Left on notice that if he breaks Hong Kong securities rules again the transgression will be treated as a criminal matter rather than a civil matter, as this case is.

In a ruling on October 19, 2016, the tribunal also ordered Left to repay HK\$1.6 million (\$206,250) of profits made while shorting the stock. The decision is expected to send a strong message that Hong Kong regulators will be tough on any form of market manipulation, which could potentially curb traders' and analysts' ability to criticize publicly-traded companies. The so-called "cold shoulder" ruling by the MMT followed an August verdict that said Citron engaged in market manipulation by spreading false or misleading information.

"Having regard to what it considers to be the profound mischief this type of activity can cause, the tribunal is unanimously of the view in this particular instance that this cold shoulder order be for the maximum period of time," said Michael Hartmann, tribunal chairman.

The SFC alleged in December 2014 that Left profited after publication of the research report knocked nearly 20 percent off Evergrande's share price. The report claimed the developer was insolvent and had engaged in fraud.

The tribunal has yet to determine the costs Left must pay but the SFC is seeking HK\$3.966 million for its expenses, in addition to government costs.

### **Regulatory policy and timing**

Hong Kong's compliance and legal professions should be aware the decision sets the tone from regulators as to the standard to which people releasing information into financial markets will be held as to its accuracy, lawyers said.

"For those involved in compliance functions, this [the Citron case] means that they should review the market misconduct provisions and train relevant personnel as to the scope of the SFO, and take steps to ensure that there are proper risk mitigation, like there being proper due diligence and supporting documents and information," Datwani said.

Doing so was especially important prior to release of information that is similar to inside information, meaning it would lead to price fluctuations unknown to persons trading the shares of the listed company involved, he said.

"If any right minded compliance officer would say how could the persons involved have done this, then it may just be SFC applying a common sense approach. However, fortunately or unfortunately, this means that much more thorough due diligence would be required prior to [the] release of information in the likes of analyst's reports," Datwani said.

### **Landmark case?**

It may be too early to say whether it is a landmark case without a final determination, given the MMT's decision in Citron looks set to be appealed.

"It is definitely important, but we have to gauge what was done and why was the cold shoulder imposed," Datwani said. "This is a complex area and pending review of the SFAT, and any [judicial] appeals, only general observations could be made."

The Citron decision was the first time the SFC has taken action against an unregulated individual for publishing a short seller report, Wu said.

"It also represented another exercise of the SFC's power to prosecute an individual not present in Hong Kong and whose objectionable publication was not published in Hong Kong. The MMT considered the violation was significant enough to warrant the imposition of the maximum penalty, a five-year ban on trading Hong Kong stocks and a return of all profits made from his trades," he said.

A compliance officer at a local asset manager, speaking on condition of anonymity, referred to former U.S. Securities and Exchange Commission chairman Christopher Cox's condemnation of the 'witch's brew of damaging rumors and short sales'.

"If the rumors are false and you publish them while shorting, well, guess what? Chances are pretty good you have committed securities fraud or market manipulation and the SFC is right to take the strongest possible action," the compliance officer said.

"Citron's report does appear to have contained a significant amount of inaccurate information and its thesis, that Evergrande was insolvent, now looks to be clearly untrue and falsifiable," he said.

In the United States, short sellers sell and issue negative research reports. If they profit it leads in many cases to class actions suits by disgruntled shareholders. The reverse could also happen where research reports are false or contain misleading information.

"The short sellers could be subject to class action lawsuits. While regulators could intervene, these would only be for appropriate cases where there are matters like frauds. In most cases, the insurers end up footing the bill," Datwani said.

Worse still, while with Citron Research, a civil case was pursued, the SFC could, in appropriate circumstances, consider a criminal market misconduct case. Additionally, the SFC has signed a memorandum of understanding with the U.S. Department of Justice for prosecutorial coordination, Datwani said. "Should this transpire, the risks could even be higher," he said, highlighting that the sanctions that Left may yet face could be greater than initially anticipated.

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